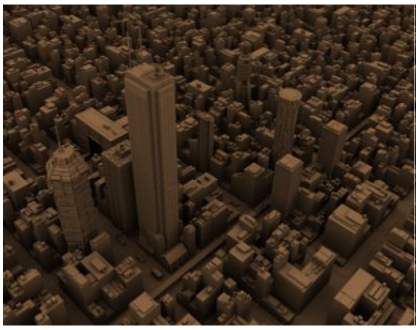
OAK INVESTMENT MANAGEMENT GROUP

FEBRUARY (1) 2012: Secondary Real Estate



During the boom of the '00s investment in real estate that had dubious growth prospects became endemic. We are still dealing with the consequences of this overhang: Large built real estate that will never achieve the raw rental income, and by consequence the capital value that had been hope for. The next five years in real estate investing will be characterised by real estate professionals distinguishing between 'good' and 'bad' secondary real estate.

Secondary real estate can be defined in contra-distinction to prime real estate. If, therefore, prime is high quality of tenant covenant, building and location, then secondary is the lack of one or all of these characteristics. It is important to note that the definition can change between country to country, region to region and sector to sector. Embedded, therefore, is a certain amount of discretion that can be a real estate investment manager's alpha or their folly.

In the good times secondary real estate masquarades as prime – but in bad times the distinction becomes quite evident. In bad times such as these liquidity dries up at 'normalised' valuations for secondary assets and flourishes for prime assets. To be fair, there is a certain amount of success bias here, as many seemingly good covenants can turn bad very quickly (especially in cyclical industries such as *inter alia* banking, insurance, real estate agencies).

In order to compete in the bad times, therefore, secondary real estate has to compete on an initial yield basis. Currently all secondary property across the European continent suffers from not being prime. But there is a yield at which (in comparison to prime) that secondary real estate becomes attractive. And, even more importantly, not all secondary real estate shares the same characteristics. Some for example, have much more 'sticky' income i.e. breaks that will not be exercised, end of lease terms that will result in a renewal rather than a vacancy, reviews that will stabilise rather than erode income on the asset.

If an investment manager is able to identify an asset that is priced as secondary real estate but behaves as a relatively stable cash flow asset then the allocation decision would be amply rewarded. On an unlevered basis even a secondary asset with an Initial Yield of 10% whose cash flows are contracting by 5% a year, would beat a prime asset holding steady at 4.5% by at least 2 times over a five year time horizon. This would be an even greater multiple a) with appropriate leverage b) on an IRR basis as the theta of the secondary asset would have less affect on returns and c) if the market saw a marginal recovery and the resulting relative convergence of capitalisation rates between prime and secondary.

So the theory stacks up well but the implementation of a correct secondary strategy requires an assured assessment of the real estate concerned. This involves understanding disruptive threats to the underlying real estate, such as identifiable risks and competitive pressures. It also means understanding cash flow threats with an analysis of the covenants associated with the underlying real estate. Clearly, this represents a welcome 'return to basics' in real estate investing.

Nicholas Frankopan is Managing Director of Oak Investment Management Group pan-European real estate investment manager. To contact the author please email nfrankopan@oakadvisors.co.uk or learn more about the group at www.oakimg.com.