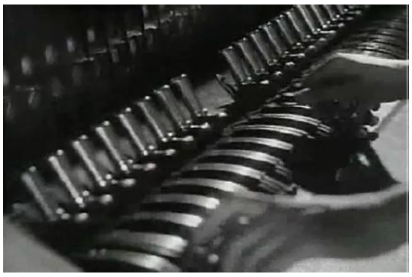
OAK INVESTMENT MANAGEMENT GROUP

MAY (2) 2012: Levers of Value in Real Estate



Many make the assumption that the price paid is the only important lever of value in real estate. This is patently not true. There are other considerations that can have meaningful impact on the value of real estate not directly related to the price paid in consideration. Understanding these can be powerful levers of value in real estate.

From the perspective of the operational performance of the asset a powerful lever of value are the explicit and implicit costs of holding real estate. Explicit costs are the actual cost of servicing a fully functioning and occupied real estate asset. This would include (but not restricted to) asset and investment management fees, capital expenditure requirements, general cost of maintenance, service charge shortfalls, non-rechargeable insurance *premia* payable. Implicit costs would be all potential liabilities. This are (but not restricted to) everything from taxes on an unoccupied real estate asset, potential environmental clean-up costs, likelihood of bad debt build up on current tenant roster, unpredicted capital expenditure requirement and inducements (rent free periods or improvements to their demise) to potential tenants.

Both of explicit and implicit costs can vary enormously depending on the sub-sector of real estate that the asset belongs to. Broadly speaking the explicit running costs in absolute and relative terms are much higher for retail, residential, light industrial and much lower for logistics and office space. This skew is exacerbated further by the fact that the former sub-sectors are more volatile in terms of covenants and term lengths which, in turn, makes those implicit costs more likely.

From the perspective of the financial performance of the asset a powerful lever of value is the availability, cost and cost of insuring (swaps) of long term funding. Real estate is a capital hungry asset class. Therefore, funding affects the entry point but perhaps more importantly the exit value of a project. For many real estate operators the cost of borrowing is more or less the hurdle rate of return on a coupon basis, and the return on equity is the redemption at the end of the investment period. Therefore, *marginal* changes in the availability and cost of funding can have an effect on both the coupon return as well as the overall liquidity in the market.

Friction costs are an important lever of value. Because most friction costs in real estate are front ended, it has a very detrimental effect on the internal rate of return (IRR) metrics of an investment; these are due diligence and tax. Anything that can be done to mitigate these, such as a clear acquisition in the former and a corporate acquisition in the later, helps an investment proposition. Capital allowances also lessen taxes payable for the lifetime of the investment – should these be available they also help the potential value of the investment. It is the role of a professional investment manager to seek all levers of value out.

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