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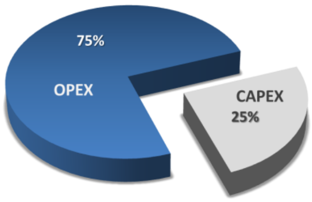
NOVEMBER (2) 2012: Capital Expenditure in Real Estate



Capital Expenditure (capex) in real estate is either the purchase of more or the marginal investment in owned real estate, the benefits of which accrue over time. Normally, in the former case new resources have to be found in order to fund expansion. In the latter case usually capex has to funded from ongoing annual cash flow or from an earmarked account held back in anticipation of such a requirement.

Except when discussing real estate exposure strategically, real estate professionals usually talk about capex as the 'ongoing requirements to service a building as a going concern.' This tactical focus on capex requirements tends to be on how much it takes to keep a building marketable to a current or potential occupier in any given year.

The key to understanding this sort of capex is forecasting true and likely requirements. Because, by definition, capex is spread over more than one financial year there are many perverse incentives to dial up or dial down the true and appropriate capex requirements. Yet, the reality is that if capex requirements are unforeseen or unbudgeted for, they are particularly destructive to the projected financial performance, and even operational viability of an asset. Equally, if capex requirements are unnecessarily built up then there is an artificial drag on performance.

Some of the major drivers of capex in real estate are: 1) the age of the building, 2) the type of building, 3) the use of the building, 4) the number of tenants in or visitors to the building, 5) the time utilisation rate of the building, 6) the durability of the construction materials of the building, 7) design / adaptability of the building, 8) the environmental climate in which the building sits, 9) previous levels of capex expended on the building, and 10) the eventual cost of *not* executing the capex in the given time period.

Capex works alongside depreciation (which is the accounting estimate of the actual life of the building) and generally speaking they are positively correlated. Therefore, an old stock of real estate is also, generally, expensive to service on an annual basis in capex terms. This means that once a piece of real estate becomes redundant it can become increasingly hard to maintain value. This precipitously affects the holder of the real estate's options as well as assumed valuation.

'Proactive' capex can also be used to try and re-position an existing asset, building goodwill or appreciation of 'good value' from existing tenants or enticing new ones to be interested in the asset. These are usually drawn up by a good building or asset manager as a matter of course and judged (where possible) on a net present value basis by the owner of the real estate to try and judge their merit. Sometimes these sorts of initiatives can be on the books for many years on a standby basis for when resources allow for their implementation.

Capex is fundamental to real estate. The perils of ignoring it are much greater than other sectors where it is 'merely' an embedded risk – in this sector it is obvious and critical. Buildings can become less useful, less appropriate and less competitive. Value can disappear completely, so it is essential to measure and weigh up carefully the value of annual resources expended on such long lived assets.

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.