OAK INVESTMENT MANAGEMENT GROUP

NOVEMBER (2) 2013

Sub-Sectors in Real Estate

Real estate is divided into major sectors of economic activity and investment. These are important for understanding the industry as much as for understanding the risk / reward ratio between each of these segments in real estate. Each have their specific and major drivers so when analysed in detail the various sectors of real estate are not homogeneous.

The major real estate sectors are: 1. the **residential sector** which is largely tied to actual household earnings; 2. the **retail sector** which is a measure of current consumption and thus the inverse of the current saving rate and thus tied to expected earnings; 3. the **industrial sector** that is related to gross domestic product; 4. the **office sector** which is linked to company earnings; 5. the **healthcare sector** which (in Europe) is, basically, a derivative of government spending; 6. the **hotel sector** that is related to company as well as household earnings; 7. the **leisure (or food an beverage) sector** that is connected to household earnings; 8. The **logistics sector** that is related to gross domestic product; 9. the **securities sector** through indirect exposure to real estate is correlated to excess cash in the system.

Portfolio theory would seek to develop ways to optimise these segments but the problem is that the cycles of investment and return are simply too great in real estate. Reaching an efficient frontier through static or backward-looking resource allocation is simply not possible. Practically, and as a result it is important to choose a sector and have the ability and wherewithal to have exposure to that segment for as long as it takes. Property as an asset class has the longest collective investment 'memory'. Practically this means that under-allocations as well as over-allocations last beyonf what is rationally correct.

What is the best way to invest in sub-sectors of real estate? The most basic essential of this is to appreciate that each sub-sector, though correlated, is fundamentally different. Each sub-sector's economic cycle is different affecting the implied hold period for each sub-class. Each sub-sector's valuation volatility is different affecting the assumed amount of leverage that it is possible and prudent to take. Each sub-sector's volume is different affecting the liquidity of a particular asset class at any one point. Each sub-sector's hold costs are different affecting the nominal or initial yield that is available at any one point for a particular sub-sector.

For cross-sector (general property) exposure it is important to have the right mix of assets and understand the tenor of the hold period. Different sub-sectors (because of their differences) can play a vital role in diversification from a risk point of view. Perhaps the most important calculation when committing to real estate in this cross-sector way is a proper understanding of the liquidity of the capital value in each sub-sector, as well as an approximation of the net coupon achievable on an annual basis. It is from this assessment that all other financial calculations can be derived.

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