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PORTFOLIO STRATEGY

by Sheila Hopkins

A Mix of Picks

Eeny, Meeny, Miney, Mo' Money

Risk is a war board game that can take hours, even days, to complete. Each side sets up its forces based on knowledge of its own strengths and weaknesses and of the enemy's. Invariably, just as all of the careful planning and maneuvering is about to bear fruit, something unexpected happens — like the cat jumps up on the table and wipes out all armies in the Balkans.

REIT investment is like *Risk.* Based on research and their clients' risk/return preferences, portfolio managers devise strategies to find the perfect REITs to fit the bill. But, as often as not, just when everything seems to be proceeding so beautifully, the unexpected cat — or capital market crunch — comes along and … *kerplooee.*

Executive Summary

- **Investment managers start their search for the best REITs by narrowing the playing field.**
- **Most money managers maintain meticulous models for forecasting cash flow, growth and price changes.**
- **But, at the end of the day, subjective judgment plays the biggest role.**

Part of the problem is the size of the game board. There are more than 200 REITs and, despite some consolidation, it has become very difficult (as if it ever was easy) to analyze each and every REIT out there. Therefore, investment managers start their search by narrowing the field. They're all looking for the same thing — companies guaranteed to make money for their investors — but they have varied methods of finding those companies and a variety of outlooks.

Matt Ostrower, vice president of Pioneer Investment Management, focuses on growth-oriented REITs with long-term cash-flow growth possibilities. Focusing on growth as opposed to income begins to limit the REIT universe. Ostrower limits his investment in community shopping center REITs, for example, because he believes that they are in a mature industry with limited growth possibilities. Hotels, on the other hand, are more interesting. He feels that recent changes in the lodging industry mean that its growth potential is higher. Ostrower also likes the fact that there are a lot of value-added possibilities that can be employed to increase returns.

Robert McConnaughey, managing director at Prudential Real Estate Securities, looks at REITs as companies and not just as collections of assets. "The key for us," explains McConnaughey, "is finding those companies that have an opportunity to improve their returns on invested capital to levels beyond that which currently is priced into the stock."

According to McConnaughey, much of the prospects for improvements in returns on invested capital stem from management's ability to pilot the public vehicle. Corporate management, as opposed to asset management, is a new arena for REITs, and one in which the track record is mixed. "In our view," asserts McConnaughey, "corporate capital disciplines such as those that exist at great corporations like Wal-Mart, Coca-Cola and General Electric are sorely lacking in the REIT world."

McConnaughey points out that, because real estate is such a capital-intensive business, management disciplines will prove to be of increasing importance as we enter a period of real estate equilibrium. "Therefore," he says, "we spend a great deal of time assessing management's skills."

Cydney Donnell, portfolio manager of EII Realty Securities, also believes management is the key. Her investment team looks at each property type owned by a company and determines for themselves what business strategy they believe will provide the best long-term cash-flow growth. In making this assessment, the team considers the real estate portfolio quality, including its tenants under contract. Once EII has determined a company's growth prospects based on its holdings, the investment team uses its judgment to determine if the company management has the ability to realize that projected growth.

Only after EII has determined that a company has both acceptable growth prospects and a management that can effectively implement that growth does the team look at valuation criteria to determine if the equity is a good buy. This criteria uses — but is not limited to — multiples, net asset value (NAV) and a discounted dividend model.

Ralph Block, executive vice president and REIT portfolio manager at Bay Isle Financial Corporation and a contributing editor to this publication (see Analyst's Notebook, page 36), says that his firm looks for the "best companies" if they can be bought at attractive prices: "Over any meaningful time period, these companies will provide, we think, the best total returns for their investors."

Block uses several criteria to define "best" — including the quality and depth of management, their track record and business strategy, portfolio quality, balance sheet, absence of conflicts of interest, and insider stock ownership. Block says he is looking for companies that are able to create the most value for their shareholders. This value can be created by means of development or the ability to acquire properties at very cheap prices or other strategies.

Block cautions, however, that even the best companies can be overpriced. "We don't want to own even the 'best' companies if their stocks are trading at overly inflated prices," he says. "Conversely, we will own stocks of some less-than-stellar REITs if they're trading at dirt-cheap prices, although these will be primarily trading opportunities and will not dominate the portfolio." He expects to own the best companies, on the other hand, for much longer time periods in order to maximize the compounding of per-share FFO growth and real estate value growth.


Ralph Block

Block's strategy calls for keeping turnover to a minimum. A substantial portion of Bay Isle's clients and shareholders are taxed on realized capital gains, so this strategy often requires Bay Isle to hold a slightly overvalued stock rather than sell it when it hits the firm's target price. "This may negatively affect our pre-tax performance over the short term," admits Block, "but we think it maximizes after-tax returns for most clients."

For maximum diversification, Bay Isle owns REITs in just about every sector. The firm, however, will overweight or underweight a sector substantially, depending upon the prospects for that sector and the relative values of the REIT shares within it versus the values available in other sectors.

According to Joe Rodriguez, partner and director of securities management at INVESCO Realty Advisors, his firm's strategy starts by screening the REIT universe "to eliminate the smallest REITs — generally those below a $300 million equity market cap — because they are fairly illiquid, and often have thin management teams and concentrated portfolios. If one or two managers leave, we don't want there to be a problem," Rodriguez explains. "One of the reasons why people invest in REITs is to take advantage of the liquidity and the ability to re-balance portfolios. Illiquid stocks defeat that purpose."

After narrowing the universe, INVESCO looks at the firms from a fundamental real estate perspective — the health of the underlying real estate markets, how the companies are structured, insider ownership, their management teams and what types of expertise the managements have in development, property management and acquisitions. "We look at history and management teams that have a track record of underpromise and overdelivery," Rodriguez says.

"Our overriding concern, however, is the market they're in," adds Michael Barron, director of real estate securities at INVESCO. "Good management and good locations are irrelevant if the markets aren't healthy. Even the most talented management teams will find it difficult to outperform when a REIT is operating in weak markets."

Finally, after confirming that a company is fundamentally healthy, Rodriguez determines whether or not it is attractively valued using a quantitative pricing model. "It's all about price, relative value and relative risk."

KRA Capital Management begins its list of suitable investment candidates by performing both a sector and a company analysis, explains George E. Fanady Jr., chief investment officer at KRA. In its sector analysis, Fanady assesses macro-economic factors as well as the balance between supply and demand in the various geographic markets. He reviews global, national, regional and local economic factors and capital market situations that may affect market conditions. Those factors include inflation, interest rates, unemployment, consumer spending, government policies, and levels of personal and business investment.

KRA then uses this sector analysis to determine sector weightings. Fanady notes that these macro-economic factors are fluid and, therefore, sector analysis continuously is monitored and updated.

"Historically, many REIT stocks have performed well in markets where supply exceeds demand and where opportunities for discounted acquisitions exist. Conversely, in markets where demand exceeds supply and acquisitions are expensive, REIT stocks have suffered," Fanady notes. "The market recognizes that discounted acquisitions result in above-normal future FFO growth, while expensive acquisitions provide only moderate FFO growth potential." KRA's strategy is focused on finding those discounted acquisitions.

KRA most heavily weights a company's prospects to grow FFO and increase dividend payments. Fanady feels that management's track record is a key determinant in a company's ability to grow FFO and increase dividends, and so he pays particular attention to a firm's history. "Clearly, a company's price is considered in evaluating investment opportunities," Fanady adds. "To the extent that a group of targeted companies share similar performance and management track records, we place our bets on those companies trading at discounts to their peer group."

MODEL BEHAVIOR

It's one thing to have a strategy outlining the important factors. Knowing what companies to apply those factors to is quite another thing. To help keep up with the ever-changing REIT field, money managers have dynamic models that let them forecast cash flow, growth and price changes. These models are used to funnel the stocks down to a manageable number.

INVESCO uses a quantitative regression model that compares every stock. The firm uses the model primarily to make stocks directly comparable and grade them on attractiveness. "Our quantitative model is best described as a tool to help us compare an apple to an orange," Rodriguez explains. Using this regression model, INVESCO ranks each stock in terms of relative attractiveness and then chooses those REITs that it will purchase for its diversified portfolios.

Joe Rodriguez

KRA uses models to calculate the intrinsic values of the companies it monitors. The firm compares its calculation of intrinsic value (the value of a company as a going concern) to the company's market value to determine whether a company is trading at a discount or premium to its market value. The inputs into KRA's model include property-and-company level revenue and expense items, internal and external growth estimates, and an estimated discount rate. Generally, these models are incorporated in a three-to-five-year timeframe.

McConnaughey also uses detailed financial models to assess a company's prospects. "Prudential doesn't invest in companies without having thoroughly modeled their future cash-flow opportunities and assessed the funding assumptions underlying those growth plans," he says. "Each of these models is linked to our industry sheets, through which we can compare relevant statistics across the industry."

William Morrill Jr., managing director of LaSalle Investment Management (Securities), compares its price with the value of the real estate company as a going concern (intrinsic value) and the value of underlying real estate (NAV) to determine if the price is discounted or overinflated. Some of the quantitative factors Morrill looks at in determining intrinsic and net asset values are the quality of real estate in the portfolio, its rollover schedule, what kind of assets are held, where they are located, the financial structure of the company, how much debt it has and what its coverage ratio is. Qualitative factors are more subjective; they include the REIT's organizational structure and the expertise of its management.

William Morrill

"It all comes together for us in a discounted cash-flow model," Morrill says. "We set up a discount-rate model, then look at the earnings growth of the company over several years. We add in an assumed multiple that will be achieved when we sell the stock and come up with an intrinsic value. Based on this number, we determine if the stock is a good value. If our number comes up at $20 and stock price is $15, for example, then there is a chance for appreciation and we'll look to buy. If the numbers are reversed, then we'll sell."

Block relies heavily upon proprietary valuation models. He uses three different sub-models and combines the results in varying proportions, depending upon where he thinks the industry is in the investments and capital markets cycles. One of these sub-models focuses on estimated NAV for a REIT; he then either adds a premium or takes away a discount, depending upon various factors that he thinks adds to or subtracts from shareholder value over time — including balance sheet strength, real estate opportunities and access to reasonably priced capital.

Another sub-model of Block's focuses on the net present value of all estimated future cash flows for each REIT, discounted to the present date on the basis of a specific discount rate. This model allows Bay Isle to make both long-term and short-term estimates of potential FFO and AFFO growth, to which Block applies a cap rate depending upon sector, balance sheet, management strategies and other considerations that he thinks affect investor hurdle rates of return.

Bay Isle's third sub-model is a P/AFFO ratio approach, and is based on how Block thinks other investors will value REIT stocks from time to time and what they'll be willing to pay for each dollar of AFFO. "This is our concession to relative valuation," says Block, "whereas the other models are based on absolute valuations."

THEORIES OF RELATIVITY

REITs don't exist in a vacuum. They are part of an evolving investment universe with a variety of vehicles clamoring for investment capital. After determining that a company is a viable investment, managers need to compare it to something to determine if it is the best use of an investor's money. Because REITs are a hybrid of real estate and equities, with both growth and income components, making direct comparisons to other vehicles is difficult, and exactly what comparisons should be made remains controversial.

Morrill says that he compares LaSalle's portfolio to the Wilshire, Morgan Stanley and NAREIT indices. "We try to beat the indices that have comparable securities to what we own," he says. Morrill normally doesn't see REITs compared to bonds or utilities on an index basis because they are a different investment vehicle. "Typically we are compared against our own indices," Morrill says. "We aren't being asked to beat the bond or utility stocks."

Ostrower looks at REITs as if they were equities. "REITs should act very much like their asset class," he claims. "Many people say that real estate is different than other equities, but I believe they are just another equity with one exception — they have to pay out much of their retained cash because of tax laws." Ostrower believes that REITs will trade up and down with the expectations of the market. "People increasingly are looking at REITs as cyclical stocks."

McConnaughey insists that REITs are priced against everything — against equities, bonds and utilities. "REIT executives must understand that they need to provide an investment product that can be competitive with all other investment vehicles, public and private, on a risk-adjusted basis." McConnaughey thinks that REIT executives need to make the companies more appealing to the general investor. "Quite frankly," he says, "until more company executives embrace the disciplines that have made the blue chip stocks of America great, it will be easy to ignore our sector."

Bob McConnaughey

REITs may be compared to everything, but Fanady doesn't think they should be. "It is a common misperception that REITs should be compared to bonds," he says. "Well-managed REITs obviously have an emphasis on growing future earnings and hopefully that's reflected in the share price, while bonds offer no capital appreciation when held to maturity." Fanady also asserts that the comparison between REITs and utilities is not valid, as REIT performance, due to the ability to grow FFO, has been far superior to that of utilities. That may change in the future, however, because the deregulation of utilities requires the management of utility companies to place more of an emphasis on growth than they have in the past.

So what should REITs be compared with? "We model REITs against real estate," says Fanady. "After all, the underlying assets in REITs are land and building improvements. By and large, these assets are owned and operated by entrepreneurial management teams with proven track records."

Block agrees bonds are not a good comparison, but he has used utility comparisons. "We compare opportunities in REIT investing, as well as REIT valuations from time to time, to those opportunities available in both real estate and electric utility stocks and the expected total returns from such other alternative investments," says Block. "We believe that those investments are most comparable to those of REIT stocks. We do not compare REIT stocks with bonds, as REITs are very much equity investments and not debt obligations with fixed maturity dates."

According to Rodriguez, finding a suitable comparison depends on knowing what you're comparing. "We look at REITs in two ways," Rodriguez says. "When we have clients who've hired us to be their REIT manager, our only goal is to beat *their* REIT benchmark. But in our role within our global firm, we also play a very large research role and assist other portfolio managers within our firm with data that helps them evaluate REITs relative to bonds and equities."

Morrill also notes that the benchmark a manager is using will affect what types of stocks are suitable for a portfolio: "You wouldn't want to have a lot of C-Corps in your portfolio and base performance against NAREIT."

BASIC INSTINCT

For all the strategy outlines, models and comparison, the bottom line comes down to the investment manager's subjective decision. The objective tools help narrow choices, but they are not crystal balls. It takes a human manager to make the final decision.

"Our industry sheet is not a 'black box' that generates our portfolio without significant subjective input from myself and our team," McConnaughey says in a sentiment echoed by most other managers.

REITs don't exist in a vacuum. They are part of an evolving investment universe with a variety of vehicles clamoring for investment capital.

Barron points out that all models have some inherent shortcomings. "Any model will assume that past relationships will continue into the future, but we know from experience that that doesn't always happen. However, over time, the quantitative model has complemented our fundamental research and added a further degree of discipline to our process. At the end of the day, the value that we bring as managers is the ability to reconcile both inputs with sound judgment."

Michael Torres, president of Lend-Lease Rosen Real Estate Securities, says that his company uses a quantitative model to screen the investment universe. This model plugs in factors such as management track record, experience, communication, disclosure, board composition and reputation. "But once a list is generated," admits Torres, "professional judgment is about 60 percent of the decision."

Donnell points out that a model is only as good as its underlying research. "Garbage in, garbage out," she says. It's up to the manager to decide if the listed stocks make sense for any particular portfolio.

The managers' expertise comes into play in interpreting the objective data provided by models, companies and research. And interpretations are, by definition, subjective.

Portfolio managers all have their own ideas about what the various numbers mean. "If a multiple is high, many companies will tell you their cost of capital is low," says Ostrower. "I disagree. It suggests to me that investors have high expectations of what the company can do, so I want to make sure that the company is able to meet those expectations."

Ostrower explains that the qualitative piece of the analysis tends to be extremely subjective. As a result, everyone is looking at certain criteria with different eyes. "I use my instincts a lot," says Ostrower.

THE BOTTOM LINE

A manager's instincts are becoming more and more important as the REIT industry becomes more and more complicated. It was only a $50 million industry in the 1980s. Today it stands close to $2 billion and it's growing. "We still evaluate companies about the same way we did in 1985," says Morrill. "But there is a lot more to evaluate today. There is much more management depth, development and in-house management. There are more pieces to put into the model."

As the REIT industry has matured, its strategists have matured with it. There is more professionalism and expertise than ever before. But there is also all that additional data to evaluate.

Managers in the new millennium need to be on the lookout for those stray cats that jump up every now and then. Those who are able to protect their game pieces will be the winners in the end. ❖

Sheila Hopkins is a freelance writer for **Institutional Real Estate, Inc.** Her last piece for *Institutional Real Estate Securities* was "Out of Focus," April 1999.