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Return Lift? ➡ Build To Core

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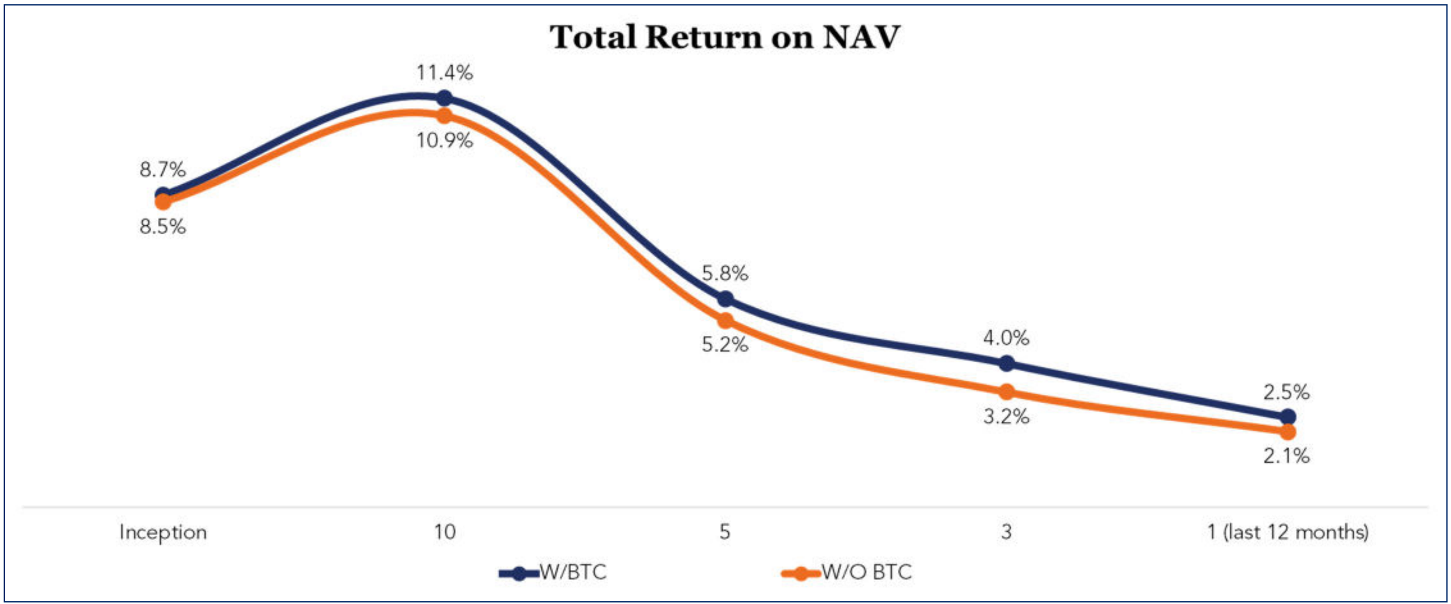
Coveted core real estate — existing Class A properties well located in the leading real estate markets — provides a more consistent income stream from durable rent rolls and steady, if unspectacular, appreciation. These assets hold value better in down markets and have accelerated rent growth in up markets. However, investor demand for yield is creating incredible demand for core real estate and led to an unprecedented accumulation of investment "dry powder" that began during the latter stages of the GFC and continues today. This yield supply/demand imbalance, coupled with very low interest rates, has created opportunities where there is a material spread between the cost to build core projects and the valuations for those core projects once built and stabilized.

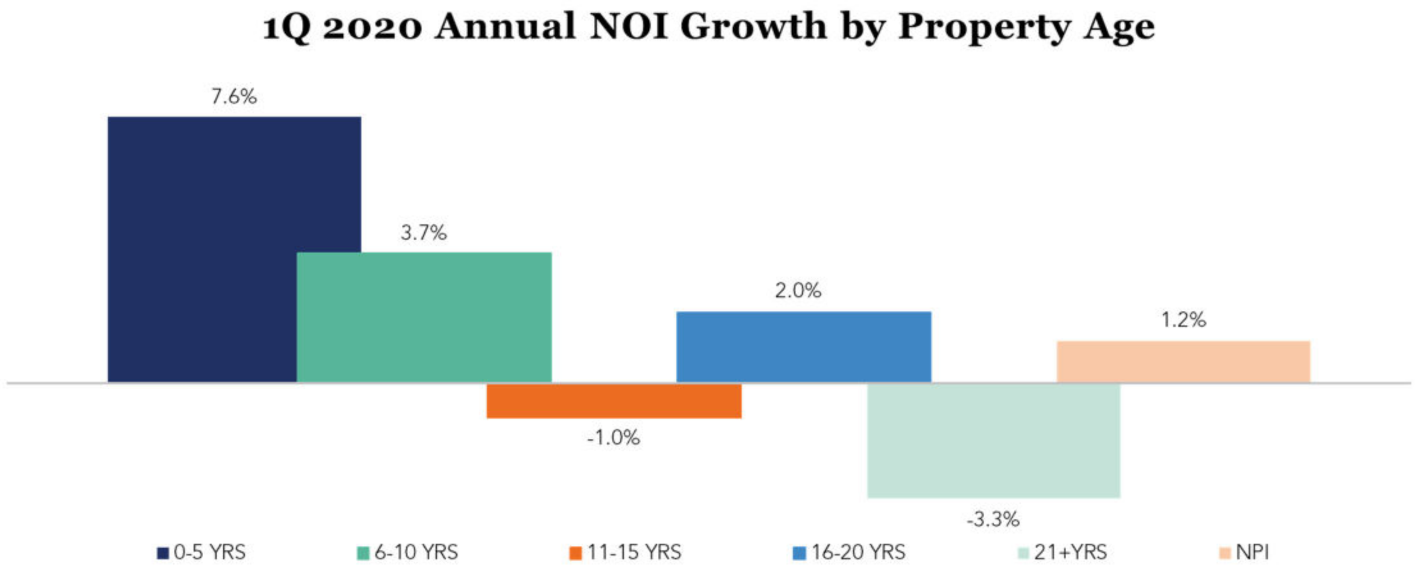
In this current low yield environment, most traditional core investors are actively searching for a differentiator or competitive advantage relative to their peer set with any incremental return. One way is to add additional leverage given the positive arbitrage metrics in the cost of debt-to-equity ratio. For those investors with leverage constraints, incremental build-to-core development may provide return lift, when executed within certain parameters while mitigating potential pitfalls.

In a vacuum, the existence of a significant spread in the return on cost to market spot capitalization rates shows the potential incremental return over buying existing assets. Although compressed since earlier in the cycle, spreads remain between 50 bps in the gateway markets to as much as 150 bps in some sunbelt suburban markets. This differential also provides potential protection in the event of cost overruns or extended leasing timelines. When incorporated in a traditional core portfolio and executed over a full cycle, the realized excess return lift is noticeable in almost all time periods. For example, the chart below shows an example of a traditional core portfolio with and without the addition of build-to-core*.



*Actual L&B portfolio return metrics

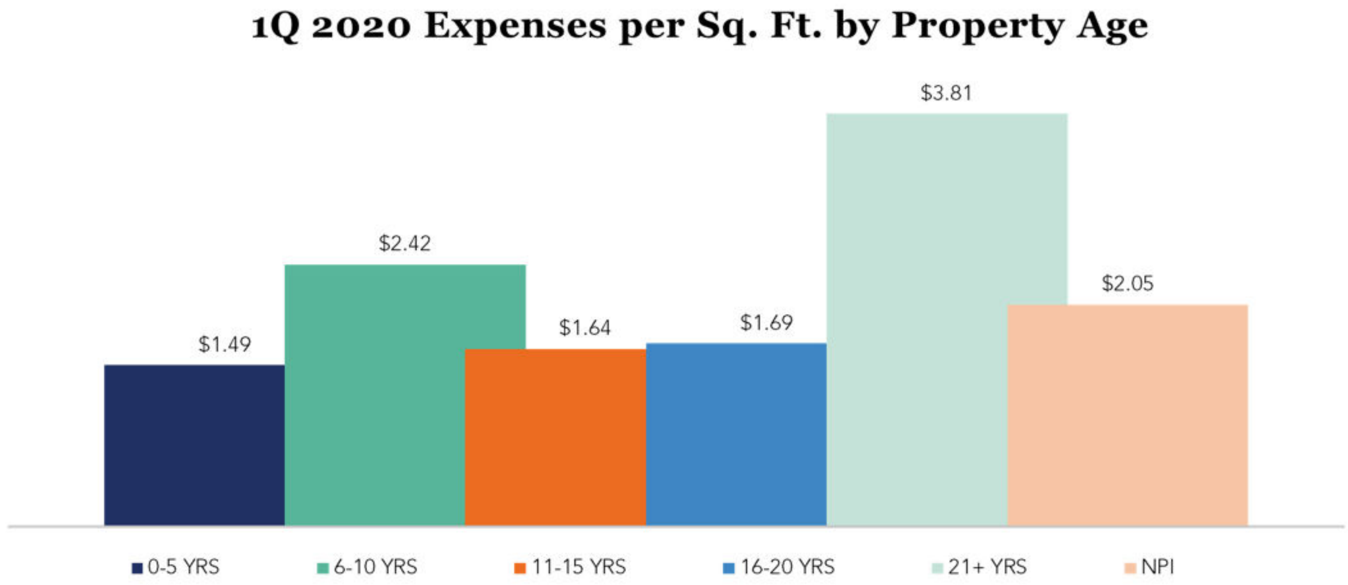
Additionally, newly delivered assets show sustained rental rate growth, increases in operating expense efficiency and outperformance relative to older comparative properties. The graph below illustrates this comparative analysis, noting the significant annual NOI growth (390 bps) differential to properties older than six years.



Sources: NCREIF and L&B Realty Advisors

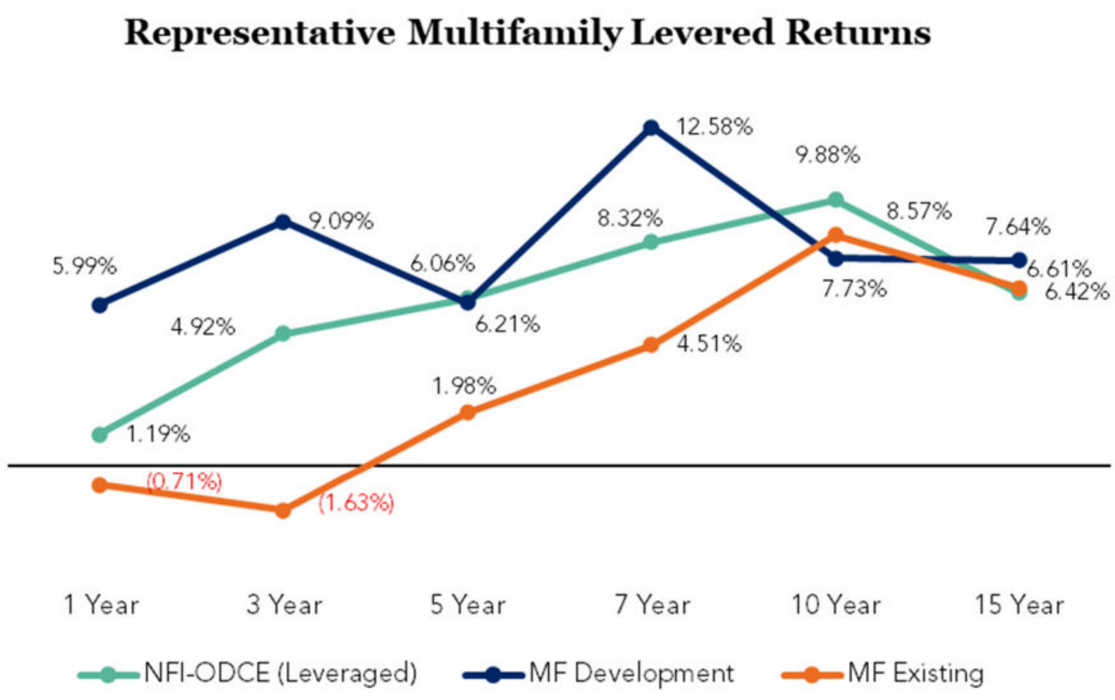
Note: contains info from all property types from NCREIF and excludes Quarters 2-4 of 2020 due to the unusual impacts of the pandemic on commercial real estate

Newly delivered assets can also facilitate execution of strategic ESG initiatives with an increased focus on responsible initiatives. Modern buildings feature more technologically efficient and sustainable systems, not to mention air ventilation and filtration systems. The implications for these newer assets are increased property performance with measurable and sustainable reduction in operating expenses delivering a win/win for both investors and tenants/residents. NCREIF operating expense information demonstrates the possible operating efficiencies achievable with newer, more modern assets. Again, the remainder of 2020 was excluded as the data contains significant noise associated with the pandemic.



Sources: NCREIF and L&B Realty Advisors

Adding a build-to-core component to a long-term strategy amplifies the total risk-adjusted return. The differential return effect is amplified in the multifamily sector where the lowered cost basis in development significantly limits the impact of underwriting misses in cost and rental rate structure. Over the recent cycle, total returns from investments in existing multifamily assets lagged build-to-core multifamily by a wide margin. The chart below shows a representative data set from an aggregation of actual L&B client data.



Notwithstanding the potential incremental return benefits, there are risks to be identified and mitigated and structural considerations prior to pursuing a build-to-core strategy. Construction costs, specifically materials and labor, have been a consistently moving target and requires deep diligence into construction budgets by real estate professional and engineers. GMAX pricing and an agreement with the partner that strictly addresses cost overruns is essential to mitigate risk. Additionally, stringent parameters around the buy/sell provisions in the partnership agreement are integral in order to hold onto the asset without being in a position to: 1) force the asset to market; and 2) pay a fair market price for the asset and preserve upside.

Investors should strongly consider taking advantage of the current investment environment and cyclical strengths in market fundamentals, specifically multifamily and industrial, by investing in non-traditional core strategies that offer downside protection and additional return potential. L&B has executed niche strategies for clients where they have the ability to invest in high quality core assets at a relative discount to market cap rates and maximizing the risk-return relationship in their core real estate portfolio.

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