Value Creation Opportunities for Commercial Real Estate Owners

How managers can separate their companies from the pack.

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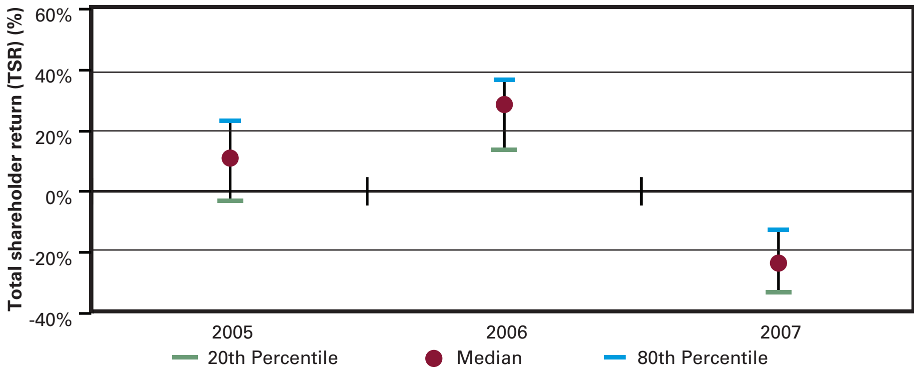
MANAGERS, UNDER constant pressure from Wall Street and with compensation plans often tied to annual performance metrics, spend a significant amount of time focusing on short-term fluctuations in stock price. However, absolute, short-term shareholder return is not a reliable indicator of a company's true performance because it is largely a function of external market conditions and is, to some extent, beyond management control. Moreover, relative annual returns change year to year, making short-term performance, even when controlling for market factors, an unreliable predictor of long-term value creation. A long-run perspective is required.

Figure 1: Annual shareholder return distributions among office and industrial REITs



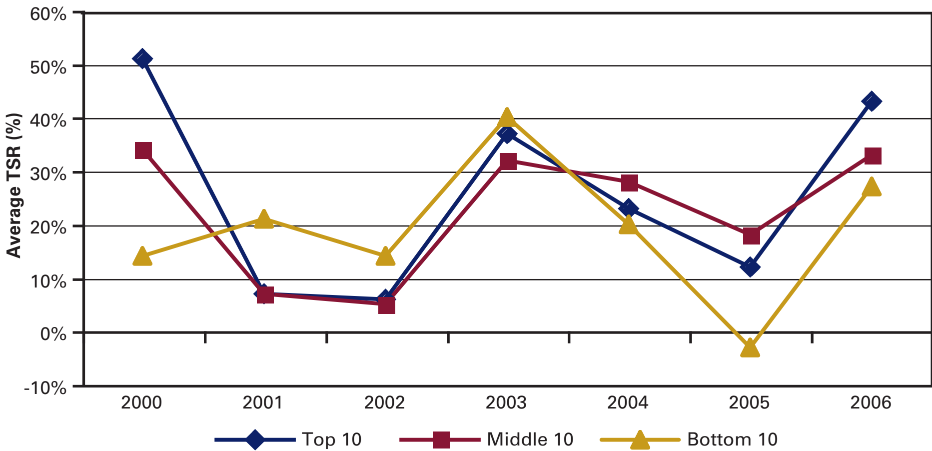
Sources: Data, SNL Financial; Analysis, FPL Associates LP

Absolute returns are highly dependent on external market conditions. In bull markets stocks rise in value, even if operating performance is subpar. In bear markets stock prices fall, even for strong performers. A stark example of this can be found by comparing the distribution of REIT returns for the most recent three years (Figure 1). In 2006 the median return was 29 percent and the 20th percentile was 14 percent—even below-average performers generated double-digit returns. In contrast, in 2007 the median return was -23 percent and the 80th percentile was -12 percent—even above-average performers lost value. Since earnings improved for most companies between 2006 and 2007, we conclude that operating performance had little to do with this widespread drop in returns.

While these returns suggest that REIT managers are at the mercy of market forces, they do not mean that companies have no control over returns. As Figure 1 illustrates, there is significant variability in annual performance across companies. In each of the past three years, the spread between the 80th and 20th percentile was more than 2,000 basis points, leaving plenty of room for strong performers to distinguish themselves. Measuring relative rather than absolute returns can therefore be a useful tool for examining cross-company variances and eliminating the effects of the broader market.

Even relative returns can be misleading in the short run, however, because they show little consistency from one year to the next. The top performers one year are equally likely to be below- or above-average the following year (Figure 2). The blue line represents the average shareholder return amongst the top ten office/industrial REIT performers in 2000. The red and yellow lines represent the middle and bottom ten, respectively. The worst performing group in 2000 (yellow line) did

Figure 2: Annual shareholder returns by 2000 tercile



Sources: Data, SNL Financial; Analysis, FPL Associates LP

better than both the other two groups in each of the following three years. This seemingly random pattern persisted throughout the past decade, indicating that relative short-term returns are poor predictors of long-term success.

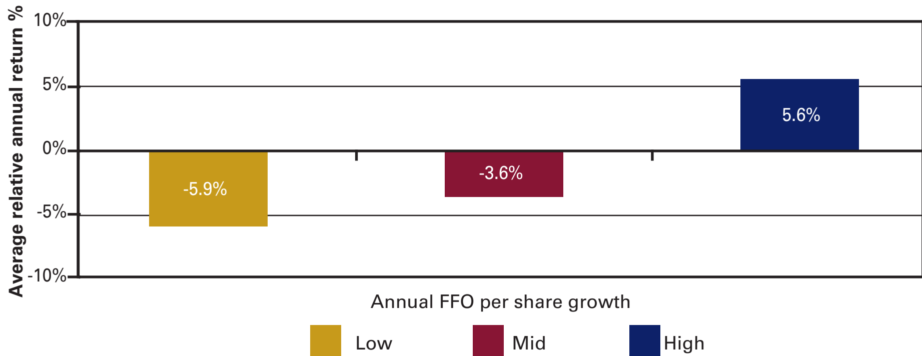
Executives should be reminded of the danger of relying too heavily on short-term goals. Significant efforts are dedicated to meeting the quarterly estimates of analysts or the annual performance targets in their compensation plans, despite the fact that doing so can actually impede value creation. It might take the form of a hasty acquisition in search of immediate growth. In other cases necessary long-term investments are delayed in an attempt to keep costs low. Either way, focusing solely on the short term is detrimental to the overall health of the company and costly for shareholders in the long run.

LONG-TERM RETURNS

The traditional view of REITs is that their high dividend yields, low volatility, and low correlations with stock prices provide investors with portfolio diversification and stable income at attractive risk-adjusted returns. However, during the recent bull market REITs behaved much more like ordinary stocks. Volatility and correlations with equity returns rose, while dividend yields plummeted. At the same time, growth rather than stable income became the primary attraction for investors.

Of all the metrics tested in our study, sustained funds from operations (FFO) per share growth was the most strongly correlated with long-run returns. During 2000 to 2006, the companies in our sample increased FFO per share by an average of 1.4 percent per year, although there was

Figure 3: FFO growth vs. long-term shareholder returns



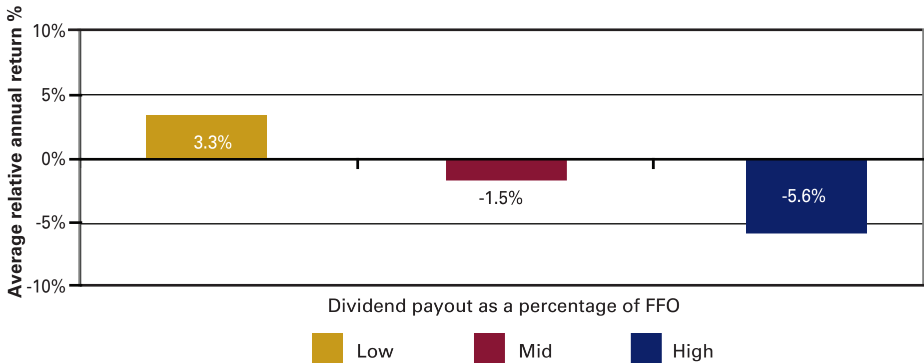
Sources: Data, SNL Financial; Analysis, FPL Associates LP

* Relative annual return equals compound annual TSR from 2000 to 2006 minus the return of the NAREIT All REITs Index over the same time.

significant variability. The top ten fastest-growing companies increased FFO by an average of 8.5 percent annually, while the bottom ten companies saw their FFO per share decline by an average of 5.9 percent. This discrepancy had a meaningful impact on returns (Figure 3). The top ten had an average annual relative return of 5.6 percent while the bottom ten came in at -5.9 percent, a healthy difference considering that these are annual figures over a seven-year period. There were few exceptions to the rule that high FFO growth companies generate above-average returns while companies with little or negative FFO growth generate below-average returns.

Analysis of dividend-payout ratios and yields provides additional evidence of REITs as growth rather than income plays. If investors were buying REITs solely because of current dividends, returns would be positively correlated with payout ratios and yields. In reality, there was a negative correlation. Dividend-payout ratios ranged from 26 percent to 129 percent, though all but a few companies were in the 50 percent to 90 percent range. Figure 4 shows the average relative returns for the bottom, middle, and top ten companies in terms of payout ratio. The bottom ten retained a larger share of earnings and generated average relative returns of 3.3 percent. Companies that paid out most or all of their cash earnings, however, generated relative returns of -5.6 percent on average. The trend is similar when looking at dividend yields rather than payout ratio. The bottom ten companies (with an average yield of 4.5 percent) had average relative returns of 6.0 percent, whereas the top ten companies (with an average yield of 7.8 percent) had average relative returns of -6.3 percent.

Figure 4: Payout ratio vs. long-term shareholder returns



Sources: Data, SNL Financial; Analysis, FPL Associates LP

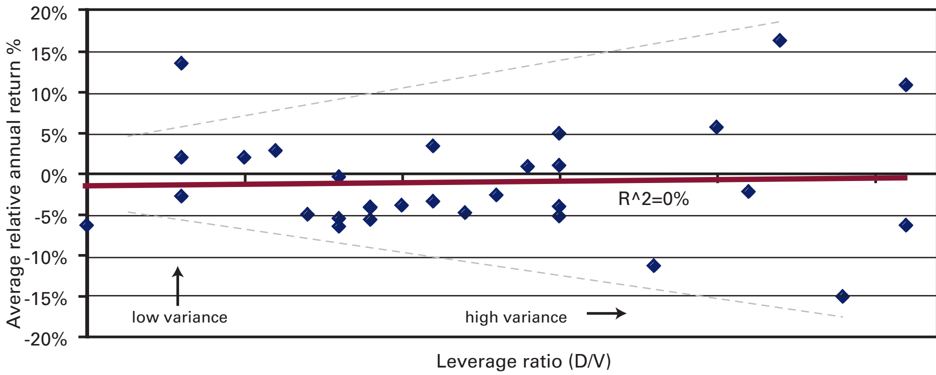
* Relative annual return equals compound annual TSR from 2000 to 2006 minus the return of the NAREIT All REITs Index over the same time.

Growth, not current yield, is the primary driver of long-run returns. It is important to note that two metrics cited in our analysis, FFO growth and payout ratio, are actually very closely related. Growing FFO requires capital, and retaining a larger percentage of earnings is one way to fund that need. Not surprisingly, there is a very strong negative correlation between payout ratio and FFO per share growth. The main distinction between these metrics is that FFO growth is a measure of past performance, whereas payout ratio is often viewed as a signal of future growth opportunities. As a result, high payout ratios are sometimes interpreted as an indicator of limited future growth and, if the ratio is high enough, unsustainable dividends.

One potential limitation of the analysis is that it covers a period when market conditions were fundamentally different from today's. While focusing on growth is a successful strategy in an environment of rising rents and falling cap rates, one might expect the opposite to be true in a down market. The traditional view is that in times of uncertainty investors shift strategies, abandoning growth plays in favor of defensive stocks with higher yields. While the data is limited and further research is needed to reach a definitive conclusion, analysis suggests that this does not always happen. In each of the last three years when REITs underperformed the market (1998, 1999, and 2007), dividend-payout ratio and dividend yield were still negatively correlated with shareholder returns among office and industrial REITs.

Though growth is the primary driver of returns, companies should not pursue it indiscriminately, as true value creation comes from growth without a commensurate increase in risk. Figure 5 illustrates the

Figure 5: Leverage vs. long-term shareholder returns



Sources: Data, SNL Financial; Analysis, FPL Associates LP

* Relative annual return equals compound annual TSR from 2000 to 2006 minus the return of the NAREIT All REITs Index over the same time.

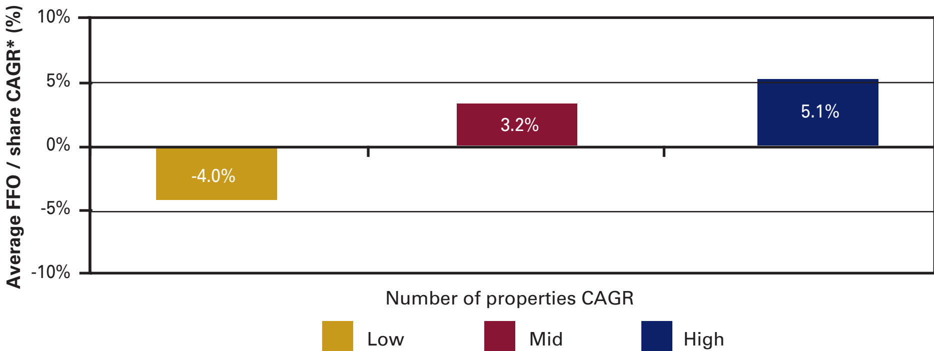
surprising finding that high levels of leverage did not lead to higher shareholder returns in the 2000 to 2006 period. This is surprising because asset values rose significantly during the period, meaning aggressive leverage could have been beneficial. While leverage did not increase average returns, it did increase volatility. Of the five companies with abnormally high or low returns, four were among the most highly levered companies in our sample. While the small sample size limits our ability to draw definitive conclusions, it appears that high levels of leverage do add risk without a commensurate increase in expected return. The ratio of variable- versus fixed-rate debt and/or short- versus long-term debt did not have a meaningful impact on returns.

So how do successful companies grow, and what does it mean to have a prudent growth strategy? Is top-line or margin expansion the solution? Is top-line growth sourced organically or through acquisitions? What are the major cost reduction opportunities for improving margins? The next two sections examine these questions and provide some thoughts on what they mean for today's REIT executive.

PORTFOLIO EXPANSION IN KNOWN MARKETS

Increasing FFO requires increased revenues or improved margins, or both. Increasing revenues, in turn, requires either organic growth (through increased rents or improved occupancy at existing properties) or portfolio expansion (through property acquisitions or development). Of these two, portfolio expan-

Figure 6: Portfolio expansion vs. FFO per share growth



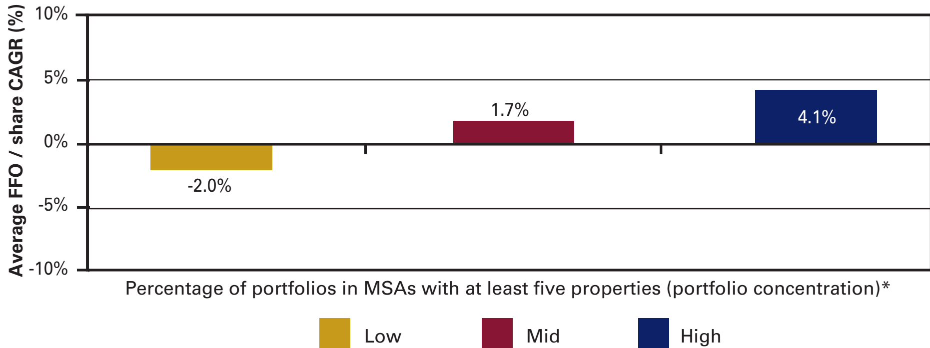
Sources: Data, SNL Financial; Analysis, FPL Associates LP
Note: Analysis spans 2000 to 2006. * Compound annual growth rate

sion is more significant than organic growth at driving increases in revenue and FFO per share. Additionally, portfolio expansion is particularly successful when it occurs in geographic markets in which the company has local scale and expertise. By focusing on a select few geographies or, for larger players, building scale in each market, companies can take advantage of local knowledge, pricing power, and operational efficiencies to realize higher margins and FFO per share.

Portfolio expansion is a primary driver of revenue and FFO per share growth. We used the annual increase in number of properties in a portfolio as an indicator of acquisition and development activity. On average, the thirty companies in our sample grew their portfolios by 3 percent per year over the 2000 to 2006 period, with individual companies varying from a minimum of -18 percent to a maximum of 43 percent. Figure 6 illustrates the unsurprising fact that companies with higher levels of acquisition and development activity were more successful at growing FFO per share. The top ten companies in terms of portfolio expansion had an average annual increase in FFO per share of 5.1 percent, whereas companies that had limited activity (or even shrinking portfolios) had average annual declines of 4.0 percent. When we analyzed revenue growth from existing ("same store") properties, organic growth had a much more limited impact on overall FFO per share changes.

Portfolio expansion is successful at driving FFO per share growth when it is pursued within markets where the company is well established. We defined each Metropolitan Statistical Area (MSA) in the United States as a unique market and "critical mass" as owning at least five properties in a single MSA. Using property-level data

Figure 7: Portfolio concentration vs. FFO per share growth

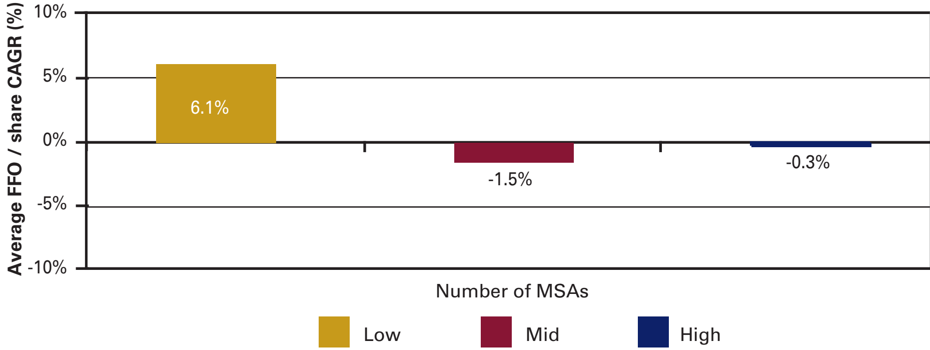


Sources: Data, SNL Financial; Analysis, FPL Associates LP
Note: Analysis spans 2000 to 2006.
*For example, if a company owns 100 properties and 12 of them are in non-core MSAs (fewer than five properties), its portfolio concentration would be 88%.

from SNL Financial, we calculated the percentage of each REIT's portfolio in markets where the company has critical mass ("portfolio concentration") and found that there was a positive correlation with FFO per share growth (Figure 7). Companies do gain advantages when they build scale in local markets.

While large national or multi-national players may be able to build scale in many markets, small or mid-size REITs cannot. This does not, however, mean that they are unable to capture the benefits of scale; rather, it suggests that they should focus on a select few geographic markets. Indeed, our analysis indicates that companies do perform better when they operate within a limited number of geographies. We considered a company to be "in" each market when it owns at least one commercial property. The number of markets is twenty on average and ranges from a minimum of one to a maximum of seventy. The number of markets in which a company operates is negatively correlated with FFO per share growth. Companies in eight or fewer markets ("low" group) grew FFO per share by 6.1 percent annually (Figure 8). The other two groups, with less geographically focused companies, both saw declines in FFO per share.

Each of the top seven companies in terms of long-term shareholder return and seven of the top ten in terms of FFO per share growth operate in eight or fewer U.S. markets. Interestingly, the "high" group, companies operating in more than twenty-two U.S. markets, actually performed better on average than the "mid" group. This result is partly driven by several very large players that operate in many markets and had strong overall performance. Consistent with our previous analysis, these high performing national players also had concen-



Sources: Data, SNL Financial; Analysis, FPL Associates LP
Note: Analysis spans 2000 to 2006.

trated portfolios (local scale). These findings further support the belief that local market scale and geographic expertise can be a powerful competitive advantage for commercial real estate investors.

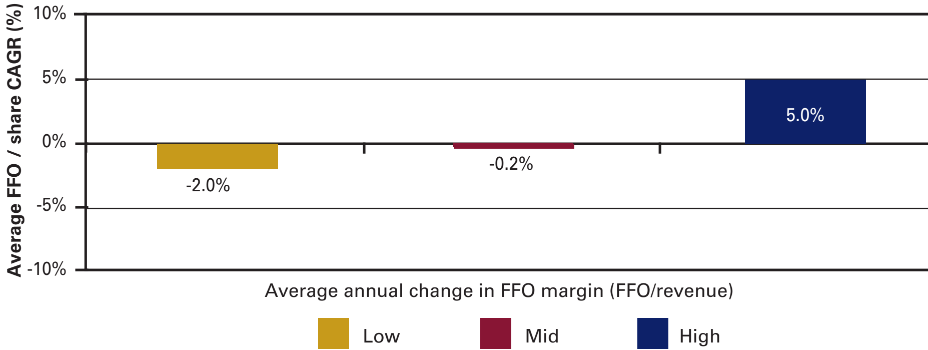
So what are the implications for REIT executives? A viable growth strategy is a must because FFO growth drives shareholder returns. For most office and industrial REITs, acquisitions and/or new developments will form the backbone of this strategy. Data suggests that this portfolio expansion is more likely to be successful if it occurs within existing target markets, though this does not necessarily mean that REITs should not expand into new regions. Expansion into new markets can be successful, but only after careful review of local market dynamics as well as fit with the existing portfolio and corporate strategy. When the decision is made to enter a new market, it should be done with intent to build depth and scale in the region.

OPERATIONAL INEFFICIENCY

A second key driver of FFO per share growth is margin control. On average, companies that were better at increasing or maintaining profit margins (defined as FFO as a percentage of revenue) saw greater increases in FFO per share. However, most companies were unable to maintain their margins as their organizations underwent significant changes over the past decade. While data does not allow us to pinpoint the reasons for this margin erosion, there are many possible causes. Analysis indicates that one possible cause is undisciplined expansion into local markets. Another potential cause is a limited focus on organizational effectiveness.

Our analysis indicates that changes in operational efficiency, or profit margin, were positively correlated with FFO per share growth. Figure 9 shows that compa-

Figure 9: Margin improvements vs. FFO per share growth



Sources: Data, SNL Financial; Analysis, FPL Associates LP
Note: Analysis spans 2000 to 2006.

nies that were most successful at maintaining their margins grew FFO per share faster than their counterparts. The top ten companies in terms of margin improvement had an average annual margin increase of just over 1 percent and grew FFO per share by an average of 5 percent annually. In contrast, both the middle and bottom groups had eroding margins and declines in FFO per share. While the top line is important, paying close attention to efficiency is also crucial for generating meaningful growth for shareholders.

As a whole, revenues grew faster than FFO for the companies in our sample, meaning overall FFO margins actually declined. FFO margin decreased for all but five of the thirty companies, with the average being -3 percent per year. This suggests that there are significant managerial challenges associated with expansion and that, despite potential scale advantages, efficiency often declines as REITs grow. What is behind this widespread erosion of margins, and what can managers do to address it?

There are many possible causes of margin erosion. Some of them are external factors outside a company's control. Higher interest rates, rising utilities costs, and declining rent or occupancy trends can all have a negative impact on margins. Other margin drivers, however, are internal factors associated with an individual company's strategy or operations. From a strategic standpoint, the choice of markets can have a significant impact. On the operational front, organizational management and design can play an important role.

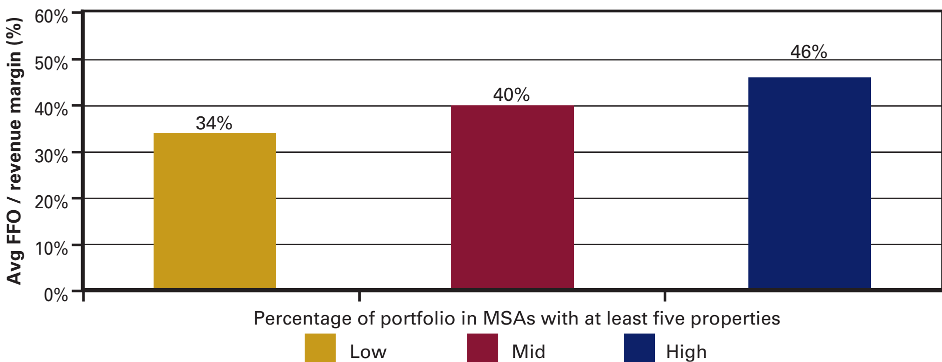
Companies that do not build scale and expertise in local markets tend to have slower, or even declining, FFO per share growth. There are many possible explanations for this, most of which have a direct impact on margins. Building local scale

may lead to pricing power and higher rents, which would flow straight to the bottom line. Any number of local operational efficiencies may result from spreading fixed or semi-variable costs (property manager salaries, office expenses) over a larger portfolio. Finally, expertise in local markets may impact margins through more savvy deal-making. Whatever the mechanism, Figure 10 illustrates that companies with concentrated portfolios, or in other words, with scale in most of their markets, have higher operating margins. The top ten companies in terms of portfolio concentration had an average FFO/revenue margin of 46 percent, whereas the bottom ten averaged 34 percent. Expanding into markets without intent to build local scale is one possible cause of margin erosion that can be avoided by adhering to a disciplined geographic strategy.

Limited attention from executives on issues of organizational management and design is another possible cause of margin erosion. Real estate executives are usually savvy dealmakers and/or experienced asset/portfolio managers. Having grown their companies from small, sometimes family-owned operations, they often find themselves in a less familiar role of managing a large organization. As a result, they can sometimes be reactive rather than proactive when it comes to structural issues. When this happens, important steps such as hiring additional staff, implementing programs, and/or changing policies occur only after problems with the existing structure have surfaced.

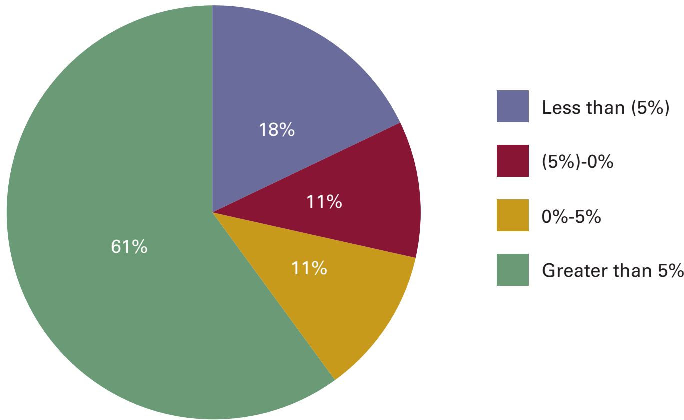
Figure 11 provides some insight into the organizational headaches facing today's REIT executives. Almost two-thirds of the companies in our sample had an average

Figure 10: Portfolio concentration vs. FFO margin



Sources: Data, SNL Financial; Analysis, FPL Associates LP
Note: Analysis spans 2000 to 2006.

Figure 11: Annual growth in employee headcount



Sources: Data, SNL Financial; Analysis, FPL Associates LP
Note: Analysis spans 2000 to 2006; figures may not add up to 100% because of rounding.

annual increase in headcount greater than 5 percent. An additional 18 percent of them had an annual decrease in headcount greater than 5 percent, leaving only 22 percent with "moderate" changes in the size of their organization.

Such significant changes in a company's size almost always necessitate careful organizational planning. This is true if the company is growing, either organically or through acquisition, and if it is shrinking, either through outsourcing or downsizing. Without such planning, inefficiencies tend to creep into the system, at best. At worst, a company's organization can become misaligned with strategy, causing significant barriers to achievement of corporate objectives. While any number of specific problems can result, some common symptoms include: difficulty attracting talent, low morale and/or turnover, declining productivity, insufficient training, political power struggles, and limited succession planning. All of these issues could potentially contribute to rising costs and the reduced margins that have limited FFO growth for many REITs over the past decade. Likewise, all of them can be addressed by thoroughly reviewing the design and effectiveness of the current organizational structure.

CONCLUSION

The purpose of our analysis is to improve our understanding of what REITs can do to maximize shareholder returns. In the short run, REIT executives have few

options, as annual returns are driven primarily by macro-economic conditions. Moreover, strong returns in any given year do not necessarily lead to long-term success, making annual returns less compelling as an objective. Our analysis suggests that executives should spend less time worrying about short-term results and instead focus on long-term value creation.

A prudent growth strategy is the core of long-term value creation. We emphasize growth because in today's world investors are no longer satisfied with stable dividend yields, and earnings growth is a primary driver of shareholder returns. However, we also recommend a "prudent" strategy because growing an organization comes with its own unique challenges and scale alone does not guarantee strong performance.

So what is the smart way to grow? While our findings do not provide all the answers, they should provide some valuable insights for executives as they develop and execute their strategy. Acquisitions and development, for example, will undoubtedly be the engine of top-line growth. While this expansion will certainly be financed to some extent with debt, leverage should not be relied on too heavily, as evidence suggests that high leverage creates risk without a commensurate increase in returns. From a geographic standpoint, this expansion is most likely to be successful if it is pursued first within existing markets in which management already has expertise. New geographic markets should be chosen carefully and entered only with intent to build depth and scale in the region. As the company continues to grow, costs will need to be closely monitored to ensure that operations are as efficient as possible. This task is much easier if future demands on the organizational infrastructure are anticipated and planned for in advance. The enterprise should be viewed not as a collection of hard assets, but instead as an operating company with all the associated complexities and challenges. These are the drivers of long-term success.