

Relatively real estate

What should institutional investors know about the opportunities and perils of investing in real estate in North America?

By James Lewis



*Nancy Holland,
head of American
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REAL ESTATE IS A GROWING PART OF THE PORTFOLIOS OF many Canadian pension funds. The real estate sector has produced attractive yields in recent years, and offers diversification and a hedge against inflation to institutional investors. Nancy Holland is head of American Property for the global property group at ABN•AMRO Asset Management in Chicago, which manages a real estate portfolio worth \$750 million. She joined the firm in 1997 as senior portfolio manager and now manages their Property Securities Fund America, the Americas portion of their Global Property Securities Fund and their Real Estate Fund. BENEFITS CANADA talked to Holland about the current landscape of North America's real estate market from an institutional perspective.

BC: *What kinds of real estate do you manage?*

NH: We're talking about commercial real estate and rental apartments, not homebuilders, real estate service providers, mortgage notes. We're talking about underlying rental income.

BC: *What do institutional investors look for in a real estate investment?*

NH: Real estate [has a low correlation] to both the S&P 500 and the bond index as well, although the correlation is a little higher to bonds than it is to equities. It has the attributes of both: there tend to be higher yields available, so it has that bond-like quality, [but] it also has the equity-like quality, because you do have growing earnings for the most part. You typically should have 10% to 20% allocation to real estate in any portfolio, unless you are extremely risk-averse or extremely aggressive.

BC: *So where are we at with commercial real estate? I know in Toronto we're still looking at quite a high vacancy rate.*

NH: You can look through all of North America and find some very high vacancy rates. Canada is certainly

doing much better than the U.S., because you're seeing the internal growth of the Canadian economy really kick in over the last two years, and that's really supporting it while the U.S. economy has lagged. That's why 5% of our U.S. portfolio happens to be invested in Canada.

BC: *On the rental apartment side, Toronto has traditionally had a very low vacancy rate, which I'm sure is attractive, but also things like rent controls and other forms of tenant protection. Do factors like this affect creditworthiness and overall desirability for investors?*

NH: Absolutely. When you're in San Francisco and New York, both of those markets also have rent control, so pricing will be dependent on the fact that you can't raise rents more than 5% for an existing tenant. A new tenant, if someone leaves, you can usually mark to market. It really depends on the marketplace. If you look at Canada and Brookfield Properties, they actually have very high-rated debt, because their debt is government debt, [guaranteed] by Canada Mortgage and Housing Corporation. That's very inexpensive financing for them.

BC: *Is there much mobility between the U.S. and Canadian real estate markets?*

NH: Yes. For the indirect companies, you have the ability of multilisting and listing freely between the Toronto Stock Exchange and the New York Stock Exchange. We own some companies that have dual listings, and I think that really brings a whole new investment opportunity to the company.

BC: *In Canada, public sector pension funds like Ontario Teachers' and the Ontario Municipal Employees Retirement System are buying buildings and shopping malls. In the United States, that's not so much the case...*

NH: No, in the U.S. it's about 50-50, where you see companies both participating in what we call the direct and indirect markets.

BC: *I would imagine direct ownership in Canada is higher than 50%...*

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NH: Oh, I would imagine it’s probably 80% plus, just because the marketplace and the opportunity set for pension investors is smaller. Hopefully, if this limited liability legislation is passed, it’s going to add to REITs’ [Real Estate Investment Trusts] appeal for pension plans.

BC: *The limited liability question here looks like it’s about to be resolved. How does that work in the U.S.?*

NH: We don’t have the limited liability issue—it’s not part of our REIT structure.

BC: *So, U.S.-based REITs have always been more attractive for Canadian investors?*

NH: Yes. That’s actually one of the reasons we didn’t invest in Canada right away: we had to get comfortable with having unlimited liability. When we bought into a company, we could lose more than our investment. Just because somebody told me that it had never happened...I didn’t want to explain that to a shareholder.

BC: *How do you explain the opportunities and perils of real estate to pension plan trustees?*

NH: I think it really comes down to what your thinking is: is [real estate] tactical or strategic? When we’re looking at companies, we’re requiring them to have 75% of their revenue be rental revenue, so we’re typically talking about longer-term leases. When we look out three to five years, we can pretty much safely predict at least a portion of a company’s cash flow, and that predictability of cash flow is what we’re talking to investors about.

BC: *Are there one or two metropolitan areas that are hot right now?*

NH: If we look at Canada, I would still say Calgary. I think it’s slowed somewhat, but it appears to be advancing again. [We’re] looking more at Montreal, but the opportunity set there for the companies we’re looking at is very limited.

BC: *How closely are commercial real estate and apartment rentals correlated?*

NH: Both of those have to do with job growth. When [you] see positive job growth, you’re potentially going to see it first in the apartment market, because it’s early-cycle, and then you’ll see it in the office market. That’s just because a company may not take on extra

space until they’re pushed to the absolute limit.

BC: *Are there a few points for institutional investors to look at or consider when assessing a real estate investment?*

NH: The first attribute we look at is management. I’ve been in the real estate industry for over 20 years now, I’ve gone through the Savings and Loan debacle here in the U.S., and I discovered that the people who succeeded through that were of the highest calibre. To get in the door, to be included, you at least have to have an above-average management team. I need to know that they can ride through the whole market cycle, good times and bad, and that they’re not going to do things exclusively for their benefit and to the detriment of other shareholders.

BC: *What should pension plans and institutional investors look for in a real estate portfolio manager? You mentioned the S&L crisis—obviously that’s good experience to have under your belt, because that’s about as bad as it gets in real estate.*

NH: It was bloody ugly, and a huge learning experience. I probably shouldn’t be saying this, but I do a jewelry test: if I walk into a room and the gentlemen seated at the table have more jewelry on than I do, we’re done.

BC: *What’s the thinking behind that?*

NH: I’ve seen too many gold chunk pinky rings and diamond pinky rings, and those were the guys who defaulted on their notes. The guys who came in modestly dressed only wanted to rework them: they were doing the best they could.

BC: *I guess one thing you want institutional investors to understand is that this is a cyclical market.*

NH: Right, and I would stress again to have diversification in the portfolio, both geographic and property type. So, I wouldn’t only own shopping centres, or office buildings in Toronto.

BC: *Do you have an outlook for the real estate market in Canada and the U.S.?*

NH: We’re looking for our Canadian companies to have 2% to 3% overall growth, and in the U.S. market for 2003 we’re expecting it to be flat.

BC: *So that’s more or less in line with the GDP. Are the two normally correlated?*

NH: [Real estate] typically has an offset correlation to GDP, so it usually lags.

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