

# Relative Values in REITs

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**Businesses of all kinds need real estate but the growth in space demand is closely linked to GDP/economic growth. Commercial real estate investment, via REITs, provides an inflation hedge coupled with a steady stream of income and a total return that is equity-like. Jim Kammert and his team utilize a systematic process to identify relative values among the various REITs with the goal of generating returns that exceed the REIT index with moderate volatility.**

## Q: What is the history of the company and the fund?

**A :** The fund is designed to provide individual investors an opportunity to invest in commercial real estate companies that are operating as Real Estate Investment Trusts in the U.S. and Canada.

Aston Asset Management is responsible for marketing and Harrison Street is the sub-advisor for the fund since July 2011. Aston is part of the Boston based Affiliated Managers Group and Harrison Street Securities (and predecessor) has been around since 2005.

Real estate as an asset class has been an attractive place to be from a total return perspective and is generally viewed as an inflation hedge. Plus, the REIT structure has a high dividend yield compared to other investment options typically.

## Q: What principles do you believe help you in guiding the investment process?

**A :** Because we are real estate sector focused we do not have to worry about picking bank stock versus a carmaker. It is all relative value within the 191 real estate stocks or REITs that we monitor on a constant basis and ideally construct portfolios that outperform a benchmark that is the index of the real estate stocks. We are bottom-up driven, meaning stock selection driven and we do not play big themes.

We utilize a disciplined investment process, a very exclusive bottom-up stock selection, driven with top down risk controls.

## Q: What is your investment process?

**A :** The key to our investment process is that we focused on a narrow list of 191 securities and are constantly searching for relative values in this select group. Our process is designed to drive all the performance we deliver on stock selection basis and not on sector rotation or having a macro theme.

We maintain property sector neutrality and by that I mean we maintain the same allocation of weights among various property types as the index. The reason we do this is because we think broad economic and property market information disseminates quickly, to all market participants, and is priced into the various property types rapidly and it is very hard to anticipate or exploit on a sustained basis.

## Aston/Harrison Street Real Estate Fund

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JAMES KAMMERT

MANAGEMENT  
James Kammert, Fund Managers

Source: Company Documents

**Mr. Kammert** is a Principal & Portfolio Manager as well as a Managing Member of Harrison Street Securities, LLC. Along with Mr. Pratt, Mr. Kammert is responsible for managing HSS's public real estate securities portfolios. Mr. Kammert joined HSS, formerly Transwestern Securities Management, in August 2005.

From 2003 through mid-2005, Mr. Kammert was Director of Research for European Investors, Inc., where he developed and maintained a comprehensive fundamental research process for the firm's U.S. REIT product, developed a stock selection model, and provided securities recommendations. Prior to joining European Investors, Mr. Kammert was Vice President and cohead of Goldman Sachs & Co.'s U.S. REIT research team for over four years. He joined Goldman Sachs from The Robinson-Humphrey Co. Inc. where he developed the firm's U.S. REIT research platform over nearly five years. Mr. Kammert's prior work experience includes over four years of commercial real estate lending with Continental Bank N.A. and two years in public accounting with Peat Marwick Mitchell.

Mr. Kammert graduated from Lafayette College with a BA in Economics & Business and earned an MBA from the University of Chicago. Mr. Kammert holds the CFA designation and is a CPA.

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We maintain sector neutrality and by doing that we are basically saying, where is the best relative value in office, malls or apartments and so on? We construct a portfolio based on stock selection, get to our sector weighting that matches the benchmark, and therefore try to drive all of our performances through stock selection and not through sector rotation or acting upon some macro-economic theme. We do not pretend to have those insights.

In the end we are trying to find relative value. Maybe malls are expensive relative to apartments but you need to find the two malls that are the least expensive and if they outperform all other malls and we pick the winners in apartments and in hotels, and so on, it should aggregate to portfolio outperformance. We do not have to worry about applying or anticipating big themes.

Within the REIT sector, public financial disclosures are detailed. We know what next quarter's cash flow should be pretty closely for these companies, barring acquisitions or disposition activity in the portfolio. Ninety-nine percent of the cash flow you had last quarter should be there next quarter because many of these leases or contracts are long term.

Given the disclosure, we have the ability to carefully measure and rate these companies and determine which REITs are generating better returns on invested capital and who is generating more free cash.

**Q: How do you come up with relative value comparisons?**

**A :** We model every company that is in our benchmark, the FTSE NAREIT All Equity REIT index. Then we value them in two different ways. We estimate multi-year cash flow for each company and discern an expected return given the relative values. We have certain standard financial variables that we apply for all property types that help us identify starting points as regards relative valuation/warranted multiple.

The other key metric is net asset value. We calculate these values in a systematic and consistent fashion for every name or benchmark that we would potentially invest in. Companies generally trade within certain bandwidths of net asset value and these ranges are fairly consistent for property types over the years.

We try to marry the two valuation metrics – the net asset value and expected return and the warranted cash flow multiple return and create a blended expected returns - and that is how you start. For each property types we rank them from the top to the bottom and are buying more of the names with the higher expected returns and sell the low expected returns. That is how we start building the portfolio subject to risk controls such as sector neutrality and avoid any concentration in one property type.

It is a very methodic, consistent and rigid application of the process. Real estate cannot trade at ethereal valuations relative to its underlying assets just because it trades on Wall Street. Investors are not going to pay beyond certain premiums to the prices paid for comparable real estate on Main Street.

The regression/warranted cash flow multiple model coupled with the net asset value estimates allows us to identify relative values across all companies and we select the best ideas for each real estate segment to construct our portfolio.

**Q: What is your research process?**

**A :** I have been doing this for 25 years, both on the buy-side and the sell-side. I have met the managers of the companies in the industry and I tour the facilities on a regular basis. That due diligence is a fundamental part.

One nice thing about real estate is that it does not pick up and move. We just continually educate ourselves about these companies by visiting with their management, doing field research, but unless there is a massive change, you do not have to do extensive amounts of new calculation at the regional level.

We know a great deal about what debts are rolling over, lease expirations, new development progress and other drivers of cash flow. One can model and project future cash flow on a per share basis and in the absolute. That gives you comfort that you have the ability to find relative value. We question how things are changing. We go out and do field research and look at new supply, new information, new competitors, and properties coming up.

The biggest threat to commercial real estate is new supply. If you have an existing 95% leased office building and none of the tenants' leases expire in the next three years, then it is more an issue if any of those tenants go out of

business. You have pretty good comfort where cash flow is for that company for an extended period of time. You can build that up property-by-property, or portfolio-by-portfolio, and then you have good visibility of future cash flow on a per share basis and in aggregate. Among other factors, we estimate internal cash flow growth projections, dividend coverage variability, and potential/capacity to raise the dividend. Are they going to make money by refinancing debt that is on the balance sheet? It is all based on trying to figure out where is the free cash flow on a per share basis that companies can generate.

That gives us good comfort to have a very concentrated portfolio and base it on relative value, because we are getting a wide snapshot for all these companies. New supply, which is your biggest impediment to rent growth and occupancy gains, is very slow to come online. Buildings just do not materialize over night, it takes years to build an apartment community or an office building, or you need several quarters to build a high-quality industrial building, and so on.

The REITs are expanding at a methodic pace- adding approximately 2% to 3% to their square footage a year while constantly optimizing their portfolio of properties. Companies change property level management/operations to improve the yield or sell underperforming properties and replace with higher yielding properties.

The REITs are big, scaled companies with very visible cash flow streams and what they do on a given quarterly basis, is generally not going to throw your expectations or investment theme materially off.

The cash flows that these companies possess today are by no means impregnable, but we have high visibility and high confidence that they are going to be there for the next two, three or five quarters.

We are not modeling for extreme events and generally take realistic view of the economy and for the real estate demand. Crisis in the future can happen but we do not plan for it and worry a lot about lot of unknowns.

You cannot forecast things that you cannot control or that are so far out of the realm of reality that I would not even be investing.

**Q: What factors drove the commercial real estate crisis in the eighties and housing market plunge five years ago?**

**A :** The eighties crisis was driven predominantly by poor tax policy. There was a huge over supply of real estate due to tax preferred limited partnerships. That was a supply problem where we built far too much real estate relative to GDP growth. Commercial real estate space demand growth is closely linked to the GDP growth and if you build too much, sooner or later you have to slow down. The bad tax policy was eliminated but industry took years to work-off the overhang of excess real estate supply and see supply/demand fundamentals come back into line.

During '08/'09 "financial crisis," the real estate cash flows really did not change at all initially in the crisis. That was a capital markets fiasco brought on by too much leveraged capital driving reckless lending through banks first who then ceased lending when the residential mortgage crisis exploded. No one could get capital regardless of the balance their sheet health. That was a suspension of belief and it just took a while for people to figure out who really was creditworthy and who was not.

Real estate stocks bounced back far harder than the S&P 500 index. From the bottom in March of 2009, REITs have tripled. REIT cash flows during the crisis declined approximately 5%, or so, but REIT share prices plunged approximately 70% from the peak in 2007 to the bottom in 2009.

Value in terms of the cash flows did not change that much, but what multiple was assigned to them changed dramatically. Markets overreacted to the down side and snapped back quickly in the second half of 2009 through 2012.

**Q: Why did REITs rebound so sharply? What advantages they accumulated after the crisis?**

**A :** We think that the REITs benefited because they had stable largely long-term debt, fixed rate financed balance sheets, and moderate leverage overall compared to the single-family home market and many poorly capitalized real estate private equity funds.

REITs actually came out of this crisis very favorably because they were good managers of capital. Going into 2006 and 2007, REIT industry was shrinking because they were selling their real estate assets at implied valuations in excess of their stock prices. They actually shrunk the balance sheets. They sold assets and bought back stock and retired debt and sold properties at peak values to these private equity buyers, and others, who were leveraged to the hilt.

The 2008 and 2009 crisis was very much a financial engineering crisis. There was a recession that thwarted the demand for space and depressed rents, but not to the magnitude that the decline in stock prices suggested. REITS rebounded when people finally figured that out.

As we sit today, the REITs exhibit an attractive blended cost of capital and wider access to capital - both in debt and equity markets and are able to buy and develop properties that are highly accretive to cash flow per share. Their cost to capital has dropped to a greater degree than the returns have on the investing side. That means they are earning more for each dollar of investing, which, in turn, means cash flow per share growth that can perpetuate the virtual cycle.

The bane of every good real estate party is too much supply and banks have tightened lending practices and have become very selective.

There are not that many developers out with the kind of wherewithal that REITs have, because, unless you are highly pre-leased you are just not going to develop the property or get financing. Across the major property types, the amount of new supply of the percentage of existing units, or apartments or industrial or office, is at multi-decade lows and with only 1% increase in supply in the market, it is a good time to be a landlord.

In addition, the cost of replacement has also gone up. The engineering and building and material costs have gone up and tenants are hesitant to move absent compelling economic motivations. The landlord with a 10-year-old property that it has kept well maintained has an advantage on a new developer because his tenants' occupancy costs are typically less than that of new development.

I think the institutionalization of commercial real estate is really playing out and with the higher amount of scrutiny, transparency and stronger balance sheets the magnitude of volatility has tightened. Also, REITs are taking advantage of low interest rate environment to refinance their debts at cheaper rates and that only increases returns on capital.

We all know how low returns are on U.S. treasuries and the rates have been low regardless of where you are on the yield curve. Real estate has acted as a great hedge against the inflation in the last ten years and should continue to do so as REITs increase their dividends and the net asset values of properties increase.

**Q: What specialty segments in the real estate sector have caught your attention?**

**A :** Life science based real estate companies have stable business models and long term sustainability. Physically, their properties resemble office building but also include lab space build out. The demand for these properties is only growing as population ages.

That would be an example that we look for a business model that looks like an office building but really its use is very different from a traditional office building with commodity like tenants such as CPA firms, local law firms, and a sale office, which might be much more susceptible to a recession or consolidation and downsizing.

Life science tenants (research institutions, universities, pharmaceutical firms, etc.) tend to cluster near one another and their underlying scientific research spans years. As such, they are not as likely to move and that translates to pricing power for landlords.

Data centers and cellular/communication tower companies are also attractive. Their rent pricing power and returns on invested capital exceed those of most commercial landlords.

The amount of mobile data traffic and explosive growth in the digital data generation are certainly driving the demand for towers and other kinds of telecom/data connectivity related real estate. The space demand growth is secular and there are not that many places where you can build these facilities where the late comer has the advantage to compete effectively.

Once you have these data center installations with \$1,500 to \$2,000 per square foot of total development costs and you have several of the major telecom companies wired into the properties the interconnection potential for the tenants is high and such tenants are not likely to just pick up and move down the street.

Such companies have better demand and supply characteristics than the typical office/commercial REITs. There is still lot of supply overhang in the office market but tower and data centers are getting better rents and generating returns on capital that are above most other property types yet are trading at or below where suburban office landlords are trading.

I will invest any time the secular demand function and twice the return on invested capital because in the end that has to translate to better cash flow growth and dividend growth than the other real estate companies that are less

profitable.

**Q: How many names do you hold in the portfolio?**

**A :** Between 25 and 30. And the benchmark index is FTSE NAREIT All Equity REIT Index. The index has nearly 140 names and we track about 191 real estate focused companies overall currently.

**Q: How do you define risk and how do you manage it?**

**A :** We have clear views of our goals and how we are expected to generate returns. I think investors invest in REITs as a proxy to commercial real estate investing, as, at the end of the day, and in the end they reflect the underlying cash flow generated by high quality properties.

I think the biggest risk is then we do not deliver a commercial real estate like return through our portfolio over a business cycle. We try to deliver that by having sector neutrality and not playing major economic themes. We have a concentrated portfolio because we believe in our bottom-up relative value identifications that meet our strict valuation guidelines. We are always fully invested and do not time the market.

Historically, our tracking error and our beta, relative to our index, have not been that considerable. You do not need to own 50 or 100 stocks to deliver the comparable risk with 30 or so names, if you define risk as moderate variation from your benchmark but generation of an intended total return of 150 to 250 basis points in excess of the index.

In addition, we are employee owned company. Further, we have pledged to hold our assets to only a level whereby we can hopefully generate a targeted 150 to 250 basis point of annualized total returns above the index with acceptable tracking error.

Moreover, we have restricted to not have more than 10% of capital in companies that are not in the index and that also offers another way to control risk.