# Churn, churn, churn?

## *Or is "buy and hold" for the Byrds?*

by Roy Schneiderman and Oliver Cowan

A few years ago, driving along a Los Angeles freeway, a colleague suggested someone should examine whether more real estate transactions occur than are really necessary. His hypothesis was there are so many people with a vested interest in transactions occurring — not only the brokers involved, but also attorneys, a host of acquisition (and, to a lesser extent, disposition) consultants, people arranging new financing, accountants, etc. And from a fee perspective, an asset management firm might have an acquisition fee and, in some cases, a disposition fee.

His suggestion was not that some cabal involving service providers is churning real estate assets like stock brokers were sometimes accused of back in the day when people could still make a very good living encouraging customers to buy and sell stocks. Rather, the thought was simply enough people have an interest in transactions that there would be a natural tendency to find reasons to sell (and then reinvest) rather than hold.

Institutional investors themselves may even contribute a bit toward this tendency. For quite legitimate reasons, undertaking hold/sell analyses is both reasonable and prudent. And at some point, there may be a human tendency toward "sell" to justify the exercise. Furthermore, benchmark-driven investors may find themselves

transacting to rebalance their portfolios to better reflect a benchmark with shifting portfolio weightings.

But is trading in and out of properties worth the cost? Or, put another way, how much better does a new investment need to perform to justify the costs of selling one asset and purchasing another? The analysis below tries to quantify this issue. It is not a rigorous academic study, but rather some quantitative noodling that may prompt a more thorough look at the question.

### A hypothetical scenario

We take, as our starting point, a $100 million core asset generating a 5.0 percent income return and appreciating 2.5 percent per year during an anticipated 10-year hold, then add 50 percent initial leverage. We hypothesize two managers each holding this mythic asset.

- Manager A holds the asset for the entire 10-year period.
- Manager B holds the asset for five years, but at the five-year point believes a better return for comparable risk can be achieved by selling this asset and buying a new core asset.

As simple as these two scenarios seem, many assumptions need to be made to generate results. One critical assumption is how to deal with the lag between the sale of the first asset and the purchase of the second. Many institutional real estate departments are not evaluated based upon their ability to keep capital invested; uninvested capital simply disappears from their evaluation. "Cash drag" is a well-known and well-established issue, however, although it is often thought of more in terms of liquidity reserve than time-friction between assets. Nevertheless, ultimately, pension funds and other institutional investors are trying to generate dollars with their capital, and so we do consider the lag, or gap between investments, as part of the analysis.

The conclusions are presented below for two outcomes. Outcome one assumes the second asset for Manager B performs only as well as the original asset. Thus, over the 10-year period, Manager B's performance is worse than Manager A's performance because of the extra transaction costs incurred in trading assets, plus the loss of income during the "down time" between the sale of the first asset and the purchase of the second asset. (See "Outcome one," below left).

Although the outcome does not represent a worst-case scenario, it does act as something of a downside scenario. That is, "What are the results if, at the end of the day, the second asset performs identically to the first?" In this scenario, roughly half of the drop in profit was due to out-of-pocket costs related to the additional transactions, with most of the rest of the drop in profit being attributable to the two-quarter downtime before reinvestment.

Of course, if the performance of the second asset for Manager B is better than the performance of the asset which is being held by Manager A, the results will be different. Rather than create a set of arbitrary inputs to represent such "better" performance, we query: How much better would the second asset need to perform for Manager B to achieve the same IRR over the entire 10-year period as Manager A? The answer is a net 10.7 percent IRR for the second asset, or roughly 180 basis points higher than the overall IRR for the asset held by Manager A for the entire 10-year period. These results are summarized in the tables to the left. (The small variances from zero in profit and multiple in "Outcome two," below left, simply represent the impact of the time value of money).

In some respects, "Outcome two" is the more interesting outcome. From the perspective of the investor making a decision at the end of year five, the issue would be whether it is reasonable to believe Manager B could find a new investment with similar risk that would generate a projected 10.7 percent return, compared with the 8.9 percent IRR anticipated to result from simply holding the first asset another five years. Staying within the same general risk level, this would appear to be a high hurdle to clear, although by no means impossible.

In addition, there may be any number of real-world reasons it would be a good idea to trade

**Outcome one: second asset performs only as well as first asset**

| | (10-year performance) | | |
|---|---|---|---|
| | Manager A | Manager B | Difference |
| Portfolio IRR | 8.9% | 8.0% | 90 bps |
| Profit | $53.6m | $46.6m | $7.0m |
| Multiple | 2.1x | 1.9x | 0.2x |

**Outcome two: both managers achieve same IRR**

| | (10-year performance; second asset net IRR = 10.7%) | | |
|---|---|---|---|
| | Manager A | Manager B | Difference |
| Portfolio IRR | 8.9% | 8.9% | 0 bps |
| Profit | $53.6m | $54.4m | ($0.8m) |
| Multiple | 2.05x | 2.07x | (0.02x) |

*Source: Bard Consulting*

out of the first asset and into the second. The purpose of this modeling exercise is to put the hold/sell decision into a broader cost-benefit framework from an institutional investor's perspective.

### Assumptions and analyses — to everything there is a season

Both managers invest in assets with core characteristics — income return of 5.0 percent and annual capital appreciation of 2.5 percent. For simplicity, no changes in market conditions across the analysis period are modeled. Debt is assumed at 50 percent LTV, a 4.50 percent interest rate, and interest-only with a 0.75 percent fee. Both managers charge an acquisition fee equivalent to 50 basis points of gross asset value and an asset management fee of 40 basis points of GAV but are not entitled to any promote or disposition fee. Both managers incur all-in sales costs of 1.75 percent of the sales price and, in the two-quarter lag time while Manager B searches for a second investment, cash earns 1.00 percent per year. Last, Manager B reinvests (and borrows against) the uplift in capital value when buying the second asset.

To determine the sensitivity of the results, individual runs were performed on the following factors: lag time between investments ranging from zero quarters to four quarters; leverage ranging from unlevered to 75 percent leverage; capital value appreciation ranging from 0 percent to 6 percent; and fees being 25 percent higher/lower. Recall that in the initial analysis, Manager B had a 90 basis point loss in IRR if its second asset simply performed to the same level as Manager A's overall performance.

Most scenarios analyzed vary as expected, although not always in a linear fashion. Varying only one factor at a time, IRR differences range from 50 basis points to 140 basis points, with lag time, not surprisingly, being the most sensitive variable, with the 50 basis point figure representing no lag time at all.

At some point, Manager B's performance can overtake Manager A's if appreciation is high, as Manager B will realize the uplift of the first five years and borrow against it to buy a larger asset for the second five years. Manager B and the fellowship of brokers, attorneys and consultants would need market appreciation of more than 10 percent each year, however, before Manager B could catch the slow-and-steady Manager A. ❖

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