RCLCO
REAL ESTATE CONSULTING

Industry Role Strategy

Chapter 7 Supplementary Information

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As discussed in Chapter 7 of *Strategy for Real Estate Companies* defining a real estate company's industry role strategy is, perhaps, one of the most important decisions that a company will make.

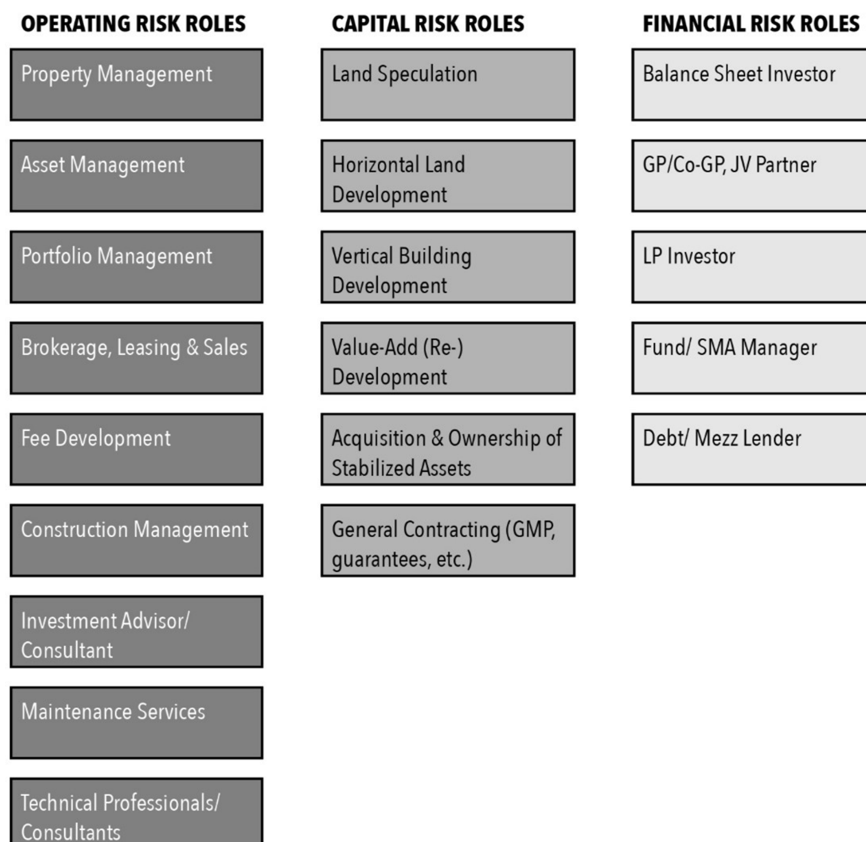
Industry roles define the real estate sectors, customer segments, businesses, and activities in which the company intends to be active, as well as what investment strategies and risk profiles the company intends to pursue. More than any other strategy pillar, the industry role strategy defines what the scope and character of the enterprise will look like, who the players will be, and what they will need to know.

Decisions made about your company's industry role(s) have implications for many other elements of the company's strategy, including what kind of skill sets and competencies a company will need, what type of human capital is necessary, the amount and type of capital that will enable the company to succeed, and so forth.

To build a balanced strategy, real estate companies must understand the risk implicit in the different sources of cash flow available to market participants. As alluded to above, there are three basic types of activities in the real estate industry that have their own risk and reward profiles. They are:

INDUSTRY ROLES	
Operating Risk	Activities, which typically involves fee income activities that put only the company's working capital at risk
Capital Risk	Activities which typically involve investing one's own– or investors' or partners'–equity capital for real estate development or acquisition
Financial Risk	Activities which typically involve decisions around whether to solely invest internal or "house" capital vs. "other peoples' money" (OPM)

A graphical representation of the major operating risk, capital risk, and financial industry roles your company could consider is presented below.



Operating Risk Roles

The universe of real estate operating risk roles share a common characteristic of generally carrying only operating risk—that is, the fee alone is at risk—while the overhead and/or working capital necessary to fund the business is relatively modest. Besides their lower level of risk, nearly all operating risk businesses have a similar financial structure. Working capital typically equal to 10 to 20 percent of the business's annual revenues is permanently invested in the company. This capital primarily funds the company's accounts receivable, although it also might amortize startup costs.

Service business profitability is typically targeted at 20 percent of revenues, although some firms have achieved margins as high as 25 percent or more, and some have lower margins. Thus, a company can usually fund its growth from internal sources simply by keeping some or all the profits in the business as working capital. The major exception to this financial structure is general contracting, which must tie up significant equity to obtain the bonding capacity sufficient to bid on larger contracts.

The various operating risk roles available to the real estate industry are outlined in the following sections. As noted, several of these roles also may involve an associated capital risk component.

Land Brokerage

The Role: Land brokers facilitate the sale and purchase of tracts of land. They typically represent landowners and bring together buyer and seller in a land sales transaction. They also work with buyers who are seeking properties for specific land uses. As a seller's agent, brokers try to maximize the value of the property they represent.

The Risks & Returns: Land brokerage is a typically a commission-based business, and as such, the risk associated with this operating role is typically very low and usually limited to working capital tied up in office leases, equipment, draws against commissions, etc. Individual brokers can receive handsome compensation in the upturn and mature phases of the real estate cycle. The return to the business is typically only moderate, but it can be attractive in relationship to the capital required to operate.

The Skills: Land brokers must have up-to-date knowledge of local land areas and an understanding of the competitive market, existing owners and their motivations, and the potential land uses surrounding a specific property.

Land Development Management

The Role: Land development managers facilitate the land development process for landowners and/or developers. Their responsibilities may include overseeing the planning and entitlement of land, managing capital for development projects, improving raw land—clearing and grading, installing roads and utility services, securing political entitlements, and so forth—to the point that the land is suitably prepared to accommodate vertical building development, and marketing and selling the approved, if not improved, land.

The Risks & Returns: Although this role may lead to more active involvement in a project, including bonding similar to a general contractor, fee land development managers generally serve the role of developers without taking on the associated capital risk. Returns for this role can vary depending upon the amount of participation that a land development manager can negotiate. Compensation for these services is typically in the form of a fixed fee—usually a monthly retainer—and possibly a back-end kicker tied to performance and/or profitability.

The Skills: Effective land development managers typically have a proven track record as capital risk developers. In addition to their construction management and marketing skills, they need outstanding communication skills and must be able to shepherd projects through often complex entitlement and approval processes found in local jurisdictions. They generally deal directly with various municipal agencies and neighborhood groups, which have a much greater voice in how developers design and build projects today than they have had.

Technical Professionals and Consultants

The Role: Technical professionals provide legal, architectural, land planning, engineering, traffic, parking, environmental, and other services. Market, appraisal, and financial consultants provide project analysis, including market overviews, financial feasibility studies, and marketing strategy advice, to capital risk players involved in land development, building development, acquisitions, and ownership of a stabilized asset. As part of these services, consultants may determine the highest and best use(s), optimum type and mix of uses, market opportunities, competitive positioning, product programming, market depth, potential absorption, cash flow projections, merchandising, leasing terms, and advertising required to market a project.

The Risks & Returns: The risk profile of these roles is low, typically limited to working capital and overhead. Most often technical professionals conduct their work on a fee for service basis, although some service providers are able to negotiate a performance fee for participation depending upon a successful outcome of their services. Returns are typically low to moderate compared with capital risk roles, but they can be very attractive considering the low level of capital commitment that is required.

The Skills: These roles require in-depth technical expertise and experience in the particular area of specialization, as well as access to—and the ability to analyze—up-to-date market, financial, regulatory, and other data.

Building Development Management

The Role: Like the fee land development manager, the building development manager provides development services similar to those conducted by a developer, but for a fee.

The Risks & Returns: Building development management typically involves no assumption of capital risk. While the risk profile may be low, returns can often be increased through participation in the project returns. Upon a project's successful completion, the building owner often pays the building development manager a back-end kicker or promoted interest based on successful completion in addition to the base compensation. The fee developer may have some completion guarantee risk.

The Skills: Building development managers must have all the skills of a capital risk building developer.

Equity Brokerage & Placement Agents

The Role: Investment bankers, syndicators, bankers and firms specializing in raising capital from high net worth individuals, family offices, foundations and institutional capital providers can take on the role of raising equity for capital risk players at the project, portfolio, fund, or corporate level. Equity brokers find equity sources and usually provide investment analysis and equity financing sources for both existing and proposed properties. Equity can be raised either privately or publicly and will require investment analysis, deal structuring, identification of capital sources, and transaction closing skills. Parties involved in equity formation also often provide debt formation services. Today, the line separating equity formation and debt brokerage has become blurred as more firms provide both services.

The Risks & Returns: This role may involve a moderate level of risk, since a firm may expend significant amounts of time with no guarantee that it will be able to raise the money and thus earn its fee. Compensation is generally based on a percentage of the money raised or on a fee. In some cases, a reward for project performance may also be paid.

The Skills: The equity formation role requires financial sophistication, an extensive network of contacts/sources, and the ability to access multiple sources of capital that often have changing requirements and interest levels.

Debt Brokerage

The Role: Debt brokers secure construction and/or permanent debt for capital risk players at the project or corporate level. They usually are hired to identify conventional debt sources, as well as mezzanine (which is actually more like equity than debt) and other non-bank sources of debt capital for investors and developers engaged in capital risk activities. Mortgage bankers and brokers place the funds of insurance companies, conduits, or other institutional investors into specific projects. Bank affiliates, conduits, and structured investment vehicles, collect and bundle loans to create diverse pools, which then are separated into units by the risk characteristics of each loan and

sold in the public markets. Conduits may originate themselves or use the investment of others. Commercial bankers also raise private pools (or syndications) for very large single asset or corporate financing vehicles. Once again, keep in mind that the line separating equity and debt brokerage has become blurred as more firms provide both services.

The Risks & Returns: Originators who have to warehouse loans for a short period of time until they are sold into the market only face a moderate level of risk when the market is stable. However, the risk may be substantially higher when volatility is introduced into the market. Compensation in the debt brokerage industry role is typically based on a percentage of the money raised or based on a fixed fee. The percentage is typically low, and the key to success, therefore, is attaining a sufficiently high volume.

The Skills: Like the equity brokerage role, the debt brokerage role also requires financial sophistication and the ability to access multiple sources of capital that often have changing requirements and interest levels.

Construction Management

The Role: The construction manager (or CM) role is to serve as the owner's, or investors', representative during the construction or renovation process. The CM coordinates and facilitates the on-time, on-budget construction and acts as the liaison between the development team and the general contractor. In the liaison role, the construction manager is responsible for evaluating the effects of design changes on construction timing and project cost, and incorporating these changes into the overall schedule and budget. To minimize project time and cost while maintaining quality, function, and aesthetics, the construction manager generally oversees the contracts of the general contractor during the project's bidding, award, and construction phases. Often, construction consultants provide construction managers with advice related to cost estimates for building, detailed cash flow analysis, and construction scheduling. Consultants determine the equipment and manpower needed to complete construction, anticipate timing until project completion, prepare cost estimates, and provide support to the construction manager, who supervises the construction process. Consultants can be brought in at the beginning of the construction process or at some point during the process.

The Risks & Returns: The risk profile of these operating roles is fairly low, as managers and consultants do not typically have the completion guarantee risk of a developer or general contractor fees are typically modest and are typically structured on a time and expense basis or as a percentage of the construction cost.

The Skills: Effective construction management and consulting requires state-of-the-art knowledge of all aspects of the construction process, current information about ever shifting construction and material costs, insight into the many ways contractors can increase costs, and the ability to stay on top of a demanding schedule.

General Construction

The Role: General contracting (or GC) services are used for land development, vertical building development, and value-add development projects. Typically, the GC is hired to build a specific project for a capital risk player within a defined time frame based on the plans and specifications developed by the architect and engineer. The GC may negotiate for a job or win a contract through a competitive bid based on a set of architectural drawings and project specifications. There are two basic types of contracts - fixed-price and cost plus. In a fixed-price contract—typically used when all plans and specifications are fairly complete—the general contractor agrees to complete the job for a fixed price, as long as the plans and specs do not change. However, many construction jobs are carried out on a cost-plus basis, with the general contractor marking up the actual costs by a negotiated percentage to cover overhead and profit. Cost-plus contracts are appropriate when the probable costs, such as those involved in the rehabilitation of a historic structure, are difficult to forecast. The most common contract today—the cost-plus-fixed-fee contract—is essentially a cost-plus contract with a guaranteed maximum fee. With this type of contract, the contractor and the developer share any savings.

The Risks & Returns: The risks faced by general contractors are moderate and can generally be managed, but can be painful if challenging cost overruns, guarantees, and bonding issues are encountered. Because general contractors work on very small margins, their returns are also moderate, but given the low amounts of capital at risk, the return on capital can be quite attractive.

The Skills: General contractors must have in-depth construction knowledge and the ability to work effectively with both sponsors and subcontractors. Generally, they must also have the capacity to be bonded.

Leasing/Brokerage

The Role: The leasing agent is either a tenant or owner representative who facilitates the leasing of office, retail, business park, industrial, or rental apartments. The leasing agent formulates and executes the leasing process. In the case of building development or repositioning of an existing asset, leasing usually begins well before construction is complete. Working within the constraints of all applicable laws and regulations, leasing agents respond to, and balance, the often opposing needs of the tenants and the owner(s) (the capital risk player(s)). The landlord leasing function comprises many elements, including canvassing tenants, showing space and providing relevant materials to prospective tenants. In addition, landlord leasing also involves setting lease rates and terms, specifying who bears the various operating costs, identifying the special needs of the user, and planning space. Tenant representation provides end users and tenants with advice on finding space and negotiating favorable leases.

The Risks & Returns: Risks are low and typically limited to working capital. Here too, successful leasing professionals can be highly compensated, but the returns to the business are only moderate.

The Skills: Leasing agents must have access to a sophisticated, up-to-date market database and be part of a network of leasing brokers throughout the market, whether they are officially affiliated or not.

Building Brokerage

The Role: The building broker may represent both buyers and sellers in the acquisition or sale of an existing property., Many companies specialize in a particular asset type, whether that is multifamily residential, industrial, office, etc., or have groups under the overall company umbrella that have product expertise and focus. Many of the largest commercial real estate brokerage houses have diversified platforms that offer a suite of services ranging anywhere from financial services including debt and equity brokerage, and traditional building brokerage, to property management, leasing, and construction management services. Building brokerage functions are typically commission-based services. The building broker tries to determine the value of the building based on rent performance, type of tenant profile, building location, comparable sales, and capitalization rates. Residential brokers, or Realtors TM, represent buyers and sellers in home purchases. Some companies specialize in sales and marketing of new construction, while others concentrate on the resale of existing properties.

The Risks & Returns: Risks are low and typically limited to working capital. Again, individual brokers can make hefty commissions, but the returns to the business are moderate.

The Skills: Brokers must have up-to-date knowledge of local building owners and potential buyers. Commercial brokers need to have good working knowledge and relationships with either internal or external capital market experts in their field of focus.

Property Management

The Role: Property managers take responsibility for the day-to-day operations of a building, including maintenance and operation, marketing and leasing, tenant relations and retention, preparation of the operating budget, rent collection, accounting, reporting to the asset manager or owner, and so forth. In addition, property managers oversee a wide variety of maintenance services, including cleaning, minor repairs, parking lot maintenance and management, landscape maintenance, and security. Many property management and leasing companies contract out some or all of these services. Many long-term owners, investors and development companies manage their own properties, and some even provide third-party fee management services for others. Most, if not all, publicly traded REITS, self-perform property management, but few offer property management services to third parties. They believe this is critical to their success and is an integral part of their "story." to attract capital and investors." Many private sector multifamily developers, such as Greystar, MCR, and others, also self-perform the property management industry role, arguing that while it may not be profitable by itself and consumes considerable management energy and focus, it is critical to their ability to lease-up and stabilize projects they intend to sell or have presold to institutional investors. Then there are a number of pure third-party companies that offer property management services to owners, investors and developers that have no economic ownership stake in the properties, although they may be able to secure a participation in the performance of assets above a certain baseline. In a somewhat contrarian move back in 2006, TCR sold its property management company to its employees after deciding that the low margins and the management distraction were no longer worth keeping this capability in house. This was after determining that TCR could hire competent property management services from third-party providers. TCR was predominantly a merchant builder of apartments, and it was a challenge to retain talented property management staff when the plan all along was to sell the assets upon stabilization. Crescent Communities, which heretofore has operated a largely merchant building apartment development business, made the determination from the start to outsource property management to third parties. Their strategy has been to "white label" outsource the property management function to the best quality local firms. In this arrangement, onsite leasing, property management and maintenance staff are all wearing Crescent Communities polo shirts, even though most of the staff are actually employees of Greystar and other property management companies. Crescent has the right to approve the property manager for each asset, but not the other staff, and all of the onsite staff members are required to attend "Crescent University" and receive specialized training on how to manage the buildings and deliver customer service the "Crescent Way." Brian Natwick, now President and COO of Crescent Communities, but formerly head of the multifamily group within Crescent, indicated to me that while there were some additional costs associated with the white label arrangement, they had designed with various third-party management companies, he was convinced that the level of customer service and performance of the assets and the portfolio have more than justified the additional cost. In addition, the company rid itself of management distraction and the human resources burden of managing a large property management operation and staff. Interestingly, Crescent is considering bringing property management back and self-performing this function as it migrates from a pure merchant builder to more of a long-term fund manager with major Japanese investors.

The Risks & Returns: The risks in property management are typically low, and limited to working capital and overhead, although the bar has moved up in recent years in terms of the necessary investment in systems and software required to perform this function well. Such systems and software include; enterprise software, lease optimization software, marketing and customer relationship management, business intelligence (BI), virtual tours, accounting and reporting, etc. It can also be an intensive human resources challenge given the sheer number of employees involved and the fact that it tends to be a business with a relatively high degree of employee turnover. In the past, property managers were relatively well-paid, highly qualified professionals with a finance, legal, accounting, or management background. However, rental property management fees experienced great downward pressure dropping from an average of 5 percent of annual revenues in the late 1980s to between 2 and 3 percent as of 2021. In markets where rents are high, rental apartment property management fees may have fallen below 2 percent. Often a minimum annual property management fee sufficient to cover the cost of high quality onsite and regional staff governs the market, and not a percentage of revenues. Many third-party property managers have faced extreme profit pressures, which have forced them to become much more efficient. Today, volume is critical, and only control of a large portfolio of properties has allowed operators to flourish economically, benefiting from critical mass to afford standardization systems and lower overhead per unit managed.

A thumb rule in the industry in the early 2000s was that an owner or operator needed to have a minimum of 25,000 units in order to break even, and 40,000 or more units to make any money in the business. Today that bar has moved, and the minimum threshold is probably

closer to 50,000 units to break even. As a consequence of this, there has been, and will likely continue to be, more outsourcing to larger third property management companies and consolidation among third party property management firms, such as the 2020 acquisition of the property management business of Alliance Residential Company by Greystar Real Estate Partners, LLC. This acquisition created the largest property management company in the U.S. with approximately 660,000 apartment homes under management. As of 2021, the next largest property management company according to the NMHC Top 50 Ranking was Lincoln Property Company with just over 203,000 units under management. Number 50 on this same list, the Beztak Companies, has just over 32,000 units under management.

The Skills:: Property managers must possess sophisticated skills in order to profitably handle the multiple demands of the management role. Property management professionals also must have the ability to attract, train, and retain the large numbers of managers and other staff required to manage a portfolio of properties. Property managers that self-perform maintenance services must have critical knowledge of technical systems and the ability to manage primarily minimum-wage personnel. Maintenance service providers who also act as property managers must be able to manage the inherent conflict of interest issue that can exist between containing costs and delivering customer service while also enhancing long-term asset value.

Asset Management

The Role: Many real estate companies don't differentiate between asset and property management, but these are completely different disciplines. Asset management is all about understanding and making decisions about the investment life cycle of an asset or a portfolio of properties, and is aimed at determining buy, hold and sell decisions, as well as when to possibly renovate, reposition, or recapitalize assets. Property management is all about executing the annual plan for the asset, and managing revenues and expenses while delivering upon the company's brand promise to its customers, tenants, vendors, and other internal company and external market stakeholders. No property manager likes it when I say this, the job of an asset manager includes managing the property manager. Very often, real estate companies confuse these separate disciplines and continue to self-perform the property management industry role, when in fact they would be better served to maintain control of the critical asset management role, while outsourcing the execution of property management to others. Asset managers take responsibility for advising capital risk owner's on their real estate portfolios, particularly about the portfolio's long-term value and ongoing bottom-line performance. In this capacity, asset managers may be charged with retaining and supervising the activities of consultants, brokers, and management firms to investigate, analyze, or implement the repositioning or selling of assets or classes of assets. They may also be overseeing the property managers for each of the capital risk owner's properties. At the same time, asset managers focus on the capital risk owner's entire real estate portfolio in an effort to obtain the highest possible return on long-term real estate investments. The broad objective of asset management is to maximize property value and investment returns. This means reducing expenditures when possible, finding the most consistent and highest sources of revenue, and mitigating liability and risk, among other things.

Asset management often includes asset repositioning, such as the renovation of a building to ensure its competitiveness, lease analysis, re-leasing, and other important issues that may arise in a tenant-driven asset class. Most building developers who maintain an ongoing ownership interest in a stabilized asset are also asset managers, whether they recognize it or not (and whether they charge for it or not). There are also large global asset management firms that offer real estate asset management services to large corporate and institutional owners of real estate, such as Aon. In addition, many of the largest global commercial real estate services firms provide brokerage and sales, as well as property management.

The Risks & Returns: The risk profile of this role is low, typically limited to working capital and modest amounts of overhead. Annual asset management fees typically range from 50 to 150 basis points (bps) of the asset value, significantly with the size of the asset or portfolio.

The Skills: Asset managers typically need most of the same skills that are required of a building developer, particularly if the asset must be significantly repositioned. If they provide additional services, such as property management, leasing, and so forth, they also must be able to manage the inherent conflict of interest which stems from the tension between recommending a sale of an asset and the desire to continue to collect management fees.

Investment Management and Private Equity

The Role: Over the past two decades, the real estate industry has seen the rapid ascent of very large investment management firms that focus on real estate investments, including real estate private equity (REPE) firms such as Blackstone, Brookfield, the Carlyle Group, Oaktree, BentalGreenOak, Starwood Capital, etc. There are also a number of large real estate investment managers (REIM), like PGIM, Clarion Partners, Nuveen, etc., that have significant real estate funds targeted primarily to large institutional investors looking for exposure to the real estate investments. These firms are primarily "asset allocators" in that they raise funds from high net worth individuals, family offices, institutional and sovereign wealth capital sources, and allocate capital to various real estate "managers" who then execute the real estate activities, whether that is an acquisition, Value-Add, development, or some combination, within specific target strategies. There are also a number of real estate developers that have entered the investment management business, as well as traditional REIM firms that have engaged in backward integration bringing real estate investment and development capabilities in house. The owner-operator real estate investment managers are raising funds from similar capital providers but self-perform the real estate investment activities themselves, including firms such as Crow Holdings, Greystar, Brookfield Asset Management, etc. Of course, there's not always a clean distinction between these market participants. Companies like Crow Holdings and Brookfield both invest with other real estate managers, and self-perform some investment strategies with in-house capabilities or "captured" affiliated companies.
The largest real estate investment and private equity companies typically offer a wide variety of investment vehicles and strategies, including general opportunistic funds that may invest in a variety of real estate asset classes, and targeted funds for specific asset classes and strategies, such as Core/Core+ multifamily; industrial, medical office, etc. Many of these firms also provide debt, and mezzanine financing investments and funds and are able to step in and support the real estate industry when traditional banks and lenders pull back from the market.

The Risks & Returns: Typically, real estate private equity and real estate investment management firms are able to earn an asset management fee on invested capital. They may also be able to earn other fees, such as acquisition fees, development fees, property management fees, etc., as well as getting a share of profits at the fund level above certain preferred return hurdles to their investors. The blend of "sticky" or recurring income from asset management and other fees together with the upside potential of outsized performance in a given real estate fund or portfolio, makes the real estate investment management industry role one of the most desirable and lucrative business in the real estate industry. It also explains why so many companies ranging from traditional asset/investment management to real estate investors and developers have migrated to the "fund model" over traditional one-off capitalization of real estate projects. The risks involved in this industry role mirror those of the capital risk roles of land development, vertical building development, value-add investments, etc., but are mitigated at the platform level by the fees which stabilize the company and helps mitigate the impact of the real estate cycle. But make no mistake, while the fees can be stabilizing and profitable, the "real money" is tied up in the performance of the underlying real estate in the form of profit sharing or promoted interest. An investment manager that earns a fee, but does not benefit from the promoted interest has not been successful, and is at risk of losing valued execution team members as well as new and repeat investors.

The Skills: Investment management and real estate private equity firms need most of the skills required of a building owner, investor and developer, either by self-performing these critical real estate activities, or having the ability to underwrite and manage the execution of same by their chosen managers. In addition, these companies must have expertise at raising capital since many of these companies are raising funds constantly, while others do so on a sequential basis. They must have excellent investor relations (IR) and reporting capabilities. Successful investment managers and private equity firms must be able to demonstrate a strong track record of successful investment relative to widely available performance benchmarks.

Pension Fund Advisor/Consultant

The Role: Real estate pension fund advisors provide a variety of services to private and public pension funds, and others, with regard to their overarching real estate strategy. Such services include; asset allocation and targeted real estate sector strategies, plus providing advice and guidance on manager or fund selection. They also underwrite support for individual investments to ensure they are consistent with the strategy, and ongoing asset management services. Some pension funds have sizable internal real estate investment management teams, but many prefer to outsource this role to pension fund advisors, such as the Townsend Group (now a subsidiary of Aon), CIGNA, LaSalle Advisors, etc. Pension fund advisors usually oversee the various investment managers who manage the assets of pension fund companies, but they do not actually make the investment or manage the assets owned by the fund. Despite the potential conflicts, many pension fund advisors also offer their own investment vehicles, or fund of fund investments, directly to their pension fund clients.

The Risks & Returns: The risk to a pension fund advisor is moderate, because of the need for a critical mass of data and modeling capabilities as well as the potential need to invest alongside the pension fund. The risk profile of a pension fund consultant is much lower as they do not typically co-invest or manage assets. Depending on the type of investment activity they undertake, compensation for pension fund advisors varies from a low of 25 bps to a high of 2 to 3 percent, depending upon the investment, size, co-investment, etc. This can come with a kicker that is based on the portfolio value or assets under management. Compensation for pension fund consultants tends to range between 25 and 50bps of the portfolio value.

The Skills: Both pension fund advisors and pension fund consultants must have sophisticated market research and portfolio modeling skills, as well as the ability to market to major pension funds in a consolidating business. Pension fund advisors who provide additional services, such as property management, leasing, and so forth, also must be able to manage the inherent conflict of interest issue.

Asset Workout/REO

The Role: Asset workout and real estate owned (REO) advisors are typically engaged by banks and other institutional real estate owners when they have foreclosed on a real estate asset or otherwise need to work their way out of a difficult or underperforming real estate investment. The advisors identify the market and financial problems that plague an owner's assets and prepare a workout plan for resolving those problems. Typically, a property owner retains an asset workout specialist after a specific property runs into financial difficulties, such as insufficient cash flow to cover debt service. Successful workouts do more than merely help a property owner decide whether to retain or sell an asset. They provide an understanding of all of the property's operational aspects, so that the owner can take practical steps to resolve the identified problems within current market conditions.

The Risks & Returns: Typically the risk profile for asset workout specialists is very low, with the principle risk being working capital and modest amounts of overhead. Returns are also modest, with most work conducted on a fee for services basis. However, some asset workout specialists are able to negotiate a back end kicker or transaction fee if a project performs particularly well.

The Skills: Workout specialists must have established and credible relationships with financial institutions (which tend to hold failed projects that have reverted to them), as well as development restructuring and marketing skills.

Other/Ancillary Services

The Role: The industry roles outlined above represent the major sectors, businesses and activities in the real estate industry, but there are also a myriad of other ancillary businesses or roles that real estate companies may want to explore as part of their strategic planning efforts. For example, depending upon the core business, real estate companies may want to consider synergistic operating risk roles such things as:

- Title insurance
- Home/renter insurance
- Landscaping services
- Warranty and maintenance services
- Renovation/stay-at-home services
- Security and technology services
- Sales & marketing consulting

Capital Risk Roles

Capital risk roles typically involve investing one's own, or investor(s)' or partner(s)', capital for real estate development or acquisition. These strategies typically involve the highest risk profile of any industry role, but also represent the highest potential returns when successfully executed.

Land Speculation

The Role: Land speculation, as separate or disaggregated from round-trip horizontal land development as an industry role, involves the purchase of land, typically on the periphery of a market in the path of future growth, or potentially as a "covered land play" with an existing, but underutilized land use that may be producing some modicum of income to cover the cost of carry, with the expectation that the land will increase in value over time as the market evolves. Speculators purchase or gain control of land with the aim of profiting from anticipated price appreciation, typically with no intention of entitling, improving the land, or ever engaging in development activities. They earn a profit by tying up land at a favorable price, holding it, and selling it in a future seller's market at a higher price.

The Risks & Returns: Land speculation, particularly raw or unentitled land on a market periphery, carries a relatively high risk because of the investment's lack of liquidity, the potential need for significant patient and cost-effective equity, political as well as market uncertainties, and the limited possibility of cash flow. Covered land plays that may have even modest cash flowing real estate uses (e.g., self-storage, industrial, etc.) can mitigate this risk somewhat. One of the factors contributing to the high risk is the fact that land value is typically the most volatile component in the real estate industry. Homebuilders and developers tend to buy land heavily during the upswing of the cycle, especially when they fall behind in their ability to produce lots and homes when the market is particularly hot. When the market slows down, they often find themselves with excess—and often overvalued land inventory. Homebuilders typically prefer to have two to three years of lot inventory on their books. When the market slows down, what seemed like two to three years of inventory during a peak absorption period suddenly becomes five or more years' worth of inventory. Builders then stop buying new land and try to sell their excess land, in an environment in which few or no other builders are willing to buy it. Thus begins the price cuts—something that happened to devastating impact during the GFC. Land was selling at very deep discounts from its peak prices, with very few buyers.

I can vividly remember driving through empty subdivisions and master-planned communities in places like Phoenix and South Florida in 2009 with spine roads, curbs and gutters, and utility stubs developed for hundreds and hundreds of finished lots, and not one home standing. Clearly, this was an example of poor timing, but also irrational exuberance typical among market participants who assume the good times will continue to roll. It is important to remember that land speculation can yield some of the highest returns when land is purchased at a favorable price during a downturn and sold into a recovering market. Indeed, staggering returns are possible, depending on the use of the land and the value created by that use. During the GFC a number of savvy and well capitalized land speculators were able to buy land from banks that had foreclosed for 10 cents on the dollar. However, land values can drop very quickly, and speculators and developers who are too heavily invested in land can find themselves in a difficult position. In some case, profits are usually possible only in the upturn and mature phases of the real estate cycle. Remember, both the highest risks and the highest returns come toward the end of the mature phase of the cycle, but these can evaporate quickly as the market enters a downturn.

The Skills: Land speculation requires excellent relationships with land brokers or contacts with landowners. It also demands an understanding of development trends in the metropolitan area where the land speculator operates. Land speculators need to have access to significant patient capital that does not require short-term return, and they can support only a low amount of overhead. Very often real estate companies that invest in land will do so only with no over very low leverage to protect themselves from this extreme volatility and protect themselves from having to fund, or lose, land assets with few near-term prospects for being put into production.

Horizontal Land Development

The Role: The horizontal land development industry role involves the transformation of raw land—through entitlements and physical improvements—into a site that is ready for vertical building construction. In addition to on-site improvements such as internal roads, the utility system, and lot grading, physical improvements may also include off-site improvements such as roads and utilities that serve the property.

The Risks & Returns: Land development is nearly as risky as land speculation, because of the investment's similar illiquidity and volatility, the low level of leverage typically available compared with the level available for vertical construction, political as well as market uncertainties, and the possibility of no cash flow. Given these risks, many real estate companies that take on the horizontal land development industry role will decide to do so with very little or no debt or they may use some leverage for physical improvements, but they will want to own the underlying land free and clear. However, the potential returns are almost as high as those of land speculation, particularly if the land is located in a market with a high barrier to entry (such as a community with strict growth controls) and the developer is skilled in obtaining the entitlements or zoning changes that permit a higher and better use, increased density, and the like. However, these returns can be significantly affected by the real estate cycles.

The Skills: Land development requires political skills—including the ability to obtain entitlements or zoning changes—as well as strong project management and oversight skills. Land developers must have access to patient capital that does not require short-term return during the entitlement and holding periods, as well as access to significant capital for the infrastructure construction and marketing stages. Land developers must operate with a relatively low amount of overhead during the planning and entitlement stages, and then must know how to gear up for the labor-intensive infrastructure construction stage.

Vertical Building Development

The Role: The vertical building development role calls for the vertical construction of one or more buildings (or homes) on improved land with the intent of generating cash flow by leasing or selling the structure(s). In the case of an income-producing asset, the building's value is determined by the cash flow it generates and how the market values that cash flow, regardless of land and construction costs. It is very helpful when determining whether to engage in this industry role to think about the various real estate sectors and customer segments that the company is going to pursue (or not pursue). For example, the strategy team may want to identify specific product types, such as office, industrial, hospitality, apartments, etc., and call out which of these they intend to focus on. Even within a real estate sector, a company might want to identify various subspecies of real estate customer segments with which they intend to engage. For instance a real estate company that expects to be active in the vertical building development industry role for "rental apartments" may want to be more specific, as follows:

- Conventional Market Rate Apartments
- Affordable/Subsidized
- Student Housing
- Active Adult Rental (AAR)
- Single-family Rental (SFR), or Built-to-Rent single family (B2R)

Further, the strategy team may want to indicate particular building or construction types that they are interested in pursuing, and may want to say yes to wood-frame and podium construction, but no to concrete high-rise buildings given their skill set and risk tolerance.

The Risks & Returns: There are multiple layers of risk in the vertical building development industry role. First, while many companies may not technically engage in horizontal land development activities, many commercial real estate developers do take on entitlement risk, particularly when a proposed development requires a rezoning of the intended use, or an increase in density, height, etc. However, many developers will mitigate this risk by making their purchase of the land contingent upon securing the necessary entitlements. Then there is construction risk, where construction cost overruns could require additional equity infusion, which may result in reduced ownership or lower profits for the developer. Here again, many developers mitigate this risk by outsourcing construction to third-party general contractors that bear most, if not all, of the risk (at a cost) in the form of a completion guarantee, or by agreeing to a gross maximum price (GMP) whereby the contractor takes on the risk of any cost overruns within a specified scope of work. In some instances, the developer may have the right to share in any potential cost savings with the GC depending upon the terms negotiated in the deal. Once a building is completed, the vertical building developer now faces marketing and lease-up risk. If a given building is leased or sold for lower revenues or at a slower pace than projected, this could negatively impact the value and therefore the profit share to the developer upon stabilization/completion. This risk can be mitigated and extremely lessened if a significant portion of a project is preleased or presold. There is also financing risk, initially in securing the necessary equity and debt to execute the development, but also for income-producing properties, which face the risk that there is sufficient permanent financing at a reasonable cost to take out the construction debt. And finally, there is market risk—given the long-term nature of most vertical building development projects, it is possible that a development is conceived of, financed, and under construction in a favorable market, but then delivers into a very different part of the economic and/or real estate market cycle. Many developers mitigate this basket of risks by contributing only a small portion of the equity necessary to execute a vertical development project and bringing in outside equity investors who may be guaranteed a preferred return. Then the developer is entitled to a larger share of the returns and profits above this hurdle (known as a promoted interest) as compensation for their real estate and business acumen plus their hard work, or "sweat equity." As you can imagine, with all of the risks outlined above, the expected returns from the vertical building development role are very high, although still lower than those that should be expected from land speculation and land development.

The Skills: There are various skills required to handle this complicated and diverse role. First are the comprehensive building-development skills—in permitting, construction, financing and capital formation, planning and design, and customer and marketing strategy. Building developers also must be able to navigate the often contentious political and community environments in which entitlement must be secured. In addition, vertical building development companies must have a sophisticated understanding of market and customer segment

trends and have strong project management and oversight skills. This role also requires strong capital market skills, including the ability to tap both debt and equity sources.

Value-Add Repositioning/ Redevelopment

The Role:This industry role typically involves the acquisition and repositioning of an existing asset through better leasing and management, renovation, or conversion to a better, completely different or adaptive use. As outlined above, Value-Add activities can run the spectrum from "light" to "heavy." In light Value-Add, a developer is making modest cosmetic changes, and improving the performance of an income-producing real estate asset through better/more active asset and property management, such as leasing up vacant space, etc. Heavy Value-Add is closer to the vertical building development industry role whereby an existing building may be completely stripped down to its core supporting structure and completed rebuilt for a higher and better use – and of course, there are any number of flavors in between these two bookends. As with the vertical building development industry role, it is helpful here to identify specific real estate sectors and customer segments that the company intends to focus on, as well as the ones it will not pursue.

The Risks & Returns: Assuming realistic knowledge of the market, the risk in light Value-Add activities is relatively moderate, since the asset is already built and has an operating history. However, the risk profile goes up with the increasing amount of Value-Add that is undertaken, with heavy Value-Add projects encompassing many of the risks borne in the vertical building development industry role. As a general rule, the level of risk for Value-Add is lower than that associated with new building development, but it could increase if significant marketing repositioning or renovation is required. In some instances, the risk for heavy value-add can actually be greater than that associated with new building development, because the construction risks of renovation tend to be unpredictable and therefore can be higher. For example, it can be more difficult to secure GMP pricing from a GC for an extensive renovation project as an existing older structure often yields surprises behind the walls. That being said, the potential returns for Value-Add activities can be quite attractive, particularly where the building, after accounting for the improvement and repositioning costs, can be acquired below replacement cost, which is a possibility if the property is in foreclosure or the seller needs to dispose of it quickly during a downturn. At the same time, the level of competition and enormous amount of capital chasing value-add investment opportunities can lead to lower return expectations relative to the risk, which can certainly the case in the late stages of the mature phase of the real estate cycle.

The Skills: As with vertical building development, the Value-Add industry role is complicated and demands experienced entitlement/zoning and building development talent, as well as a sophisticated understanding of trends in individual metropolitan area markets and market segments, strong project management skills, and the ability to manage the capital markets.

Ownership of a Stabilized Asset

The Role: Moving down the risk/return spectrum is the acquisition and ownership of stabilized income producing real estate assets. This industry role typically involves the purchase of an existing building with a cash flow that is reasonably predictable (Core) or may have some potential upside potential (Core+). There are a wide variety of market participants engaged in this industry ranging from large institutional and private equity investors, estate companies, public and private REITs, family offices, endowments, sovereign and high net-worth individuals and partnerships looking for a stable foundation for their businesses/portfolios, and attempting to gain exposure to real estate as an asset class, and benefit from the many tax advantages associated with real estate, including depreciation and tax-deferred exchanges. As mentioned above, it's also a good idea when defining a company's strategy, to call out specific real estate product types and segments to focus on along with those to avoid.

The Risks & Returns: The risk associated with owning a stabilized asset is generally low, particularly if a commercial building is well occupied by credit worth residents or tenants. Of course, the level of risk rises to moderate if noncredit tenants are involved. In addition, if asset owners do not maintain or improve their competitive position in the market, they may discover that their asset has grown obsolete

or needs to be repositioned. Rental apartments tend to be among the least risky income-producing asset classes. While cash flows can be affected by downturns, individuals and families need living quarters and apartment owners have the ability to influence occupancies by adjusting rents. Unlike commercial real estate assets where lease terms may get locked in for five or ten years, or even longer, owners of rental apartments have the ability to reset rents on a regular basis as annual lease-terms are consistently coming up for renewal or turning over. Given the relatively low risk profile of stabilized income producing real estate assets, owners expect only moderate returns—typically in the 6 to 10 percent range—and a predictable cash flow, particularly if the tenants are creditworthy. Historically, cash-on-cash returns have varied greatly, mostly as a function of the quantity of capital that is chasing real estate, the performance of other investment alternatives, and the rate of inflation. Owners of stabilized assets have the ability to pull tax-free money out of the asset through refinancing, are able to benefit from depreciation, and regularly engage in tax-deferred exchanges of assets to restart the depreciation clock and rebalance portfolios.

The Skills: Ownership of a stabilized asset requires experience and talent in asset management and marketing as well as an understanding of market and submarket trends. Ownership typically requires a substantial amount of equity as the amount of debt available is typically 60 to 70 percent of an asset's value, depending upon asset class and quality of the cash flow. Many owners prefer maintaining lower levels of debt to avoid the risk of losing an asset in a downturn by virtue of having an interest cost that is too high relative to revenues when markets are depressed.

Financial Roles

These are not technically capital risk roles per se, but it is important to define where your company plans to play in the capital stack of capital risk investments and activities, which will begin to inform the critical capital strategy pillar of your company's strategy. It is helpful at this juncture to begin thinking about what positions and roles your company will play in the all-important capitalization of your company's strategy, and while there a wide variety of potential financial roles your company can play and many different structures, the basic categories include the following:

- **Balance Sheet Capital Provider** – in this role, your company, or its principals, will largely deploy its own equity capital to fund its real estate development and investment activity – it will take 100% of the equity risk, and will receive 100% of the potential returns and profits

- **JV/Partnership** – in structure, typically your company enters into a partnership with other developers or investors and participates in the returns commensurate with its share of the equity investments, and it may have certain rights or decision-making responsibilities, depending upon the share of the investment made

- **GP/Sponsor** – in this role, your company will play the role of the General Partner and will be responsible for executing the development or investment strategy on behalf of itself and limited partner (LP) capital – depending upon the amount of equity capital invested, the GP may, or may not, control major decisions, will likely earn return of and on equity in proportion to the other equity in the deal or fund (para parsu), plus some outsized share of the returns above certain minimum thresholds (or a promoted interest)

- **GP Co-Investor** – in this structure, your company may invest in the GP equity portion of the capital stack for a particular asset, portfolio or fund of assets – as a GP Co-investor you may be at risk for certain cost overruns, capital calls and/or pursuit costs, but you will typically earn a portion of the GP returns and promote that is not typically available to limited partners

- **LP** – as a limited partner, you are typically investing with GPs and sponsors of real estate deals, portfolios or funds, and in these structures while your exposure is typically limited to the extent of your investment and you stand first in line for returns up to a

minimum threshold, you are typically giving away some of the upside returns to the GP in recognition of the fact that they have identified and (hopefully) executed the investment strategy – and typically, in 95%/5% or 90%/10% GP/LP equity splits, the LP controls major decisions about timing and potential exit

- **Fund Manager** – in this role, your company is typically the GP or "Manager" in some type of programmatic equity investment vehicle with high net-worth (HNW), family office, and/or institutional capital, with the major difference between a "fund" and one-off investments being first, the size and scale of the investment commitment or vehicle, and second, there is typically an asset management fee earned in addition to para parsu equity returns and promoted interest

Then of course, your company could decide to provide debt to other peoples' real estate investments, and you could also provide mezzanine financing which often bridges the gap between conventional bank debt and true equity, so there are lots of potential roles and activities to be explored in this category, and we will be revisiting these concepts when we get to the capital strategy chapter later in the book.

KEY TAKEAWAYS

Determine what you are going to do, and what you are not going to do in order to focus and avoid distractions from achieving your strategic goals and objectives.

Learn the lesson from many successful multi-generational (family-owned or otherwise) real estate enterprises that have achieved strategic balance with a stable base of recurring/sticky operating income activities that enable them to take capital risk at the appropriate points in the cycle.

Define the investment strategy(ies) that you will pursue (Core, Value-Add and/or Opportunistic) in each real estate product type and/or customer segment.

Disaggregate discrete activities and make a conscious choice about the businesses and activities that you will self-perform and those that you will outsource or partner to execute.

Once you have determined the roles, product types and investment strategies that you will undertake, carefully examine and understand the risks and rewards attendant with each potential industry role.

Identify those roles, segments and activities that will be "Primary" (ones for which you will generate human and financial capital to pursue); "Opportunistic" (ones that you may consider that offer outsized returns or other strategic benefits); and "No" (ones that you will not consider under any circumstance and avoid wasting time and resources chasing) roles.

Make sure your strategy addresses the elements of Competitive Advantage and Organizational capabilities you will need to succeed in each.

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