MAGNOLIA
REALTY ADVISORS

Beware the 15% Targeted Return

Introduction

The first question investors often ask of real estate investment managers is “What is your targeted return?” To which the answer for core office properties is generally 15%. This answer seldom differs depending on the cost of debt, what 10 year treasury bonds are yielding, or any other economic factor. The phrasing of the question implies that an experienced investment manager will be the creator of this return so the investment manager should be able to accurately estimate it. If investment managers are indeed the creators of value and can accurately project future returns, then an empirical study should be able to support this 15% return assertion. This white paper intends to shed light on the plausibility of the targeted 15% return. Magnolia Realty Advisors is based in Atlanta, GA so the inquiry will focus on the plausibility of achieving a 15% targeted return in the Atlanta core office market.

Private Return Data

In order to quantify the 15% targeted return, we need to identify a data set that tracked the historical return on core office properties owned in Atlanta. The most appropriate data set is the NCREIF Property Index (NPI) which is a quarterly time series composite total rate of return measure of unlevered investment performance. As of the second quarter of 2012, the NPI tracked $2.7B of properties in Atlanta. The NPI tracks unlevered returns of properties before asset management fees. Therefore to estimate what historical returns on equity would have been, we need to estimate what asset management fees would have been, what the economic cost of debt would have been, and estimate what level of leverage would have been used.

Cost of Debt

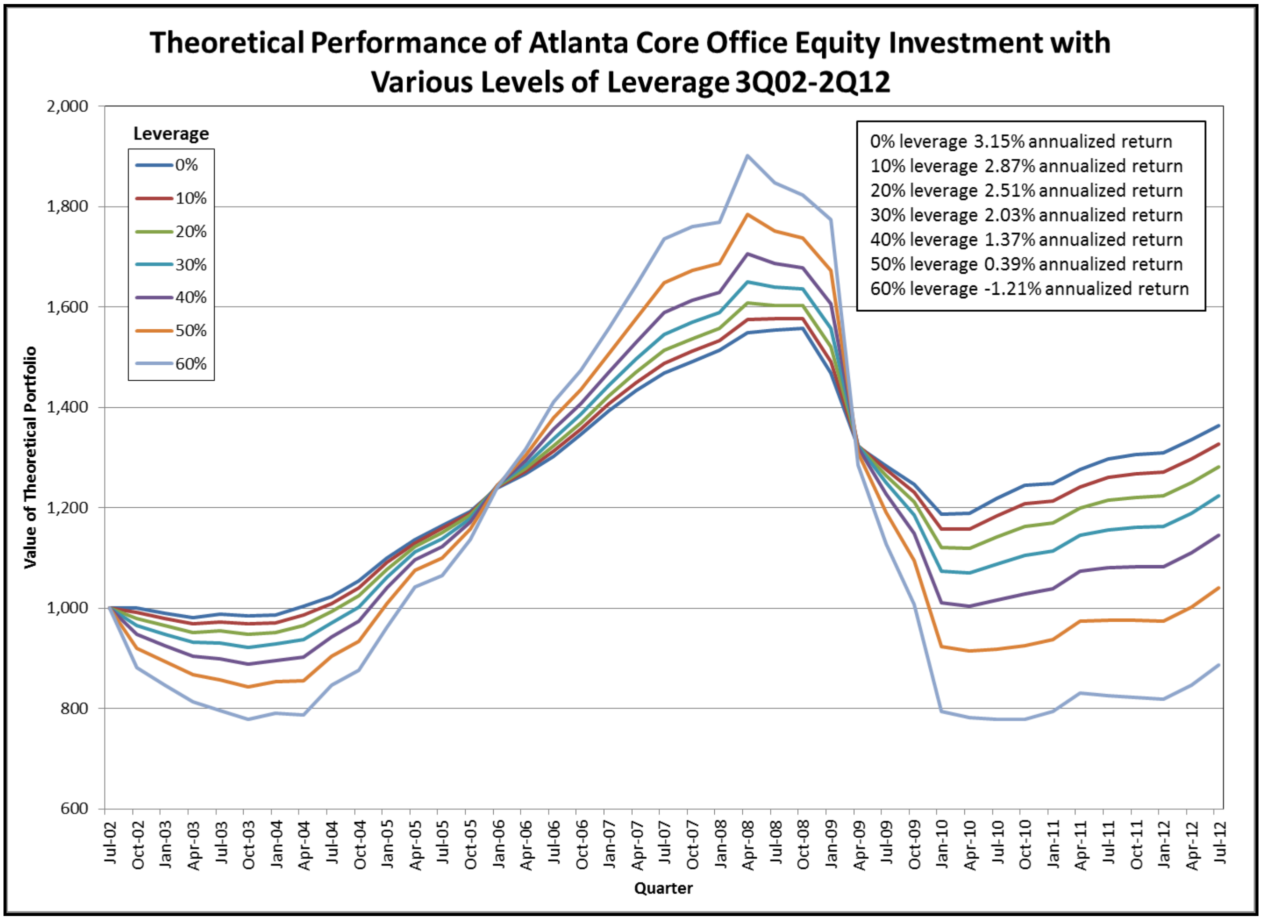
The Giliberto-Levy Commercial Mortgage Performance Index was utilized to represent the historical economic cost of debt. The Giliberto-Levy index measures both the interest return and net effect of capital appreciation or depreciation on a pool of $200 billion commercial mortgages. The Giliberto-Levy Index can be used in combination with the return on NPI tracked properties in Atlanta to estimate the equity returns that would have been achieved with various levels of leverage.

Asset Management Fees

In order to replicate the return an investor would have achieved on a property tracked by the NPI, an asset management fee was subtracted from the NPI return data. In order to estimate the fees that would have been paid by an investor, the NCREIF fund index – Open End Diversified Core Index (NFI-ODCE) was used. NFI-ODCE is an index of investment returns reporting the results of 30 open-end commingled funds pursuing a core investment strategy whose fees are similar to NPI fees. The NFI-ODCE reports both gross and net of fees and the difference between gross and net of fees returns over the previous 10 years as of the second quarter 2012 was 0.99% of assets. Therefore a 0.99% annual fee was subtracted from the NPI return data.

Results

The chart below shows the performance of theoretical equity portfolios invested in Atlanta core office properties with differing levels of debt between the third quarter of 2002 and the second quarter of 2012. As depicted in the chart, a 60% levered equity position would have achieved an annualized return of -1.21% over this 10 year period. This past performance should make one leery of investment managers who say they are targeting a 15% return on core office properties located in Atlanta as there is no historical basis on which to base this projection.



Public Equity Returns

The previous example may be a bit theoretical for some so another data point to cite is the return of Cousins Properties' (CUZ) equity. Cousins is a publicly traded REIT based in Atlanta that owns a significant amount of office properties in Atlanta along with other property types in predominately Southeastern markets. The best way to visualize the performance of their equity is with a performance chart that shows what the performance of an investment would have been had dividends been used to purchase additional stock. The advantage of looking at Cousins' equity performance is that no adjustments are required to determine what the returns for investors would have been. In addition, one can go to the website StockCharts.com and recreate the results graph by selecting a performance chart for Cousins over the same time period.

Results

The chart below shows the performance of an investment in Cousins Properties' equity in the third quarter of 2002 through the second quarter of 2012. The overall return during this time period was negative 38.3% or an annualized return of negative 4.72%.

It is likely that all of the acquisitions that Cousins made during this historical period had been pitched as having a targeted 15% return so if they had hit their targeted returns, their annualized equity return would have been 15%. To put this in perspective, if the 15% annualized return had been achieved; $1,000 invested at the beginning of the period would have increased to $4,045 at the end of the time period. In actuality, if $1,000 was invested in Cousins at the beginning of the period, it would have decreased in value to $617 at the end of the period.

Conclusion

Real estate investment managers continue to pitch a targeted 15% equity return on office properties located in Atlanta and investors sign up with these investment managers even though there is no historical precedent on which to base this projection. Investment consultants spend significant time vetting real estate investment managers and their track records using the underlying assumption that it is the investment manager who creates value for investors. Magnolia Realty Advisors has empirically shown that office properties have been systemically mispriced by market so the investment decision should instead focus on what markets to target that offer the best value. This is because historic returns achieved by an investment manager are largely a function of the markets in which the investment manager owned properties as opposed to their management skill.

By utilizing historical private and public commercial real estate return data in combination with commercial mortgage data, Magnolia has developed an innovative investment strategy based upon robust, data driven analysis.

Mr. Bollinger is the founder and CEO of Magnolia Realty Advisors. Prior to founding Magnolia, he was an analyst at KBS Realty Advisors in Atlanta, GA for 5 years where he worked on a 2 person asset management team overseeing a $500M portfolio of commercial real estate. Prior to KBS, Mr. Bollinger worked in the CMBS industry in New York City as a consultant for 3 years supporting clients such as Merrill Lynch and Bear Stearns. He earned an MBA from Vanderbilt University and a BS in Industrial Engineering from Virginia Tech.

Mr. Bollinger developed Magnolia's strategy while working at KBS and observing that the commercial real estate industry did a poor job at using the data available to it to value both individual buildings and REITs. As such, Mr. Bollinger developed a valuation methodology that incorporates all pertinent data into the valuation process. Testing this valuation method showed that it would have provided significantly better valuation estimates than the market did. This superior valuation method is the basis for Magnolia's investment strategy.