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KBS: Building a portfolio of CRE investments

With the equity and bond markets recently displaying volatility, many advisers are using alternative investment options for their clients. The advisers who use alternative investments or are analyzing alternatives for their clients' portfolios are finding some commercial real estate (CRE) investment options particularly attractive.

CRE IS NOT A GENERIC TERM

There are many different types of CRE investment opportunities, and each investment type has a different target return and risk/reward profile.

The first question to be asked is: Are you investing for cash flow for immediate yield, or are you investing for capital gain at the end of the investment?

BUILDING A PORTFOLIO OF CRE INVESTMENTS

The pyramid on this page outlines three investment tranches that can be used to build a portfolio diversified by risk/reward target return profiles.

In the CRE pyramid, assets that fall within the base section provide stable cash flow (stabilized assets) and typically are of higher quality. Thus, they have a lower risk and return expectation than assets higher on the pyramid.

Investors in the middle part of the pyramid typically focus on "value-add" real estate, where the sponsor expects to enhance the value of the asset by making significant improvements to the building. These improvements cost money and, thus, there is often very little, or any, cash flow distributed to investors in the first few years of ownership.

Assets at the top of the pyramid have a much higher target return profile than the other two tranches and, thus, are typically significantly riskier. The +15 percent return profile is for ground-up development projects. There might be no cash flow for years as the project is built. Investors may achieve gains in their target ranges if the assets are sold at levels significantly higher than the development and financing costs of the project.

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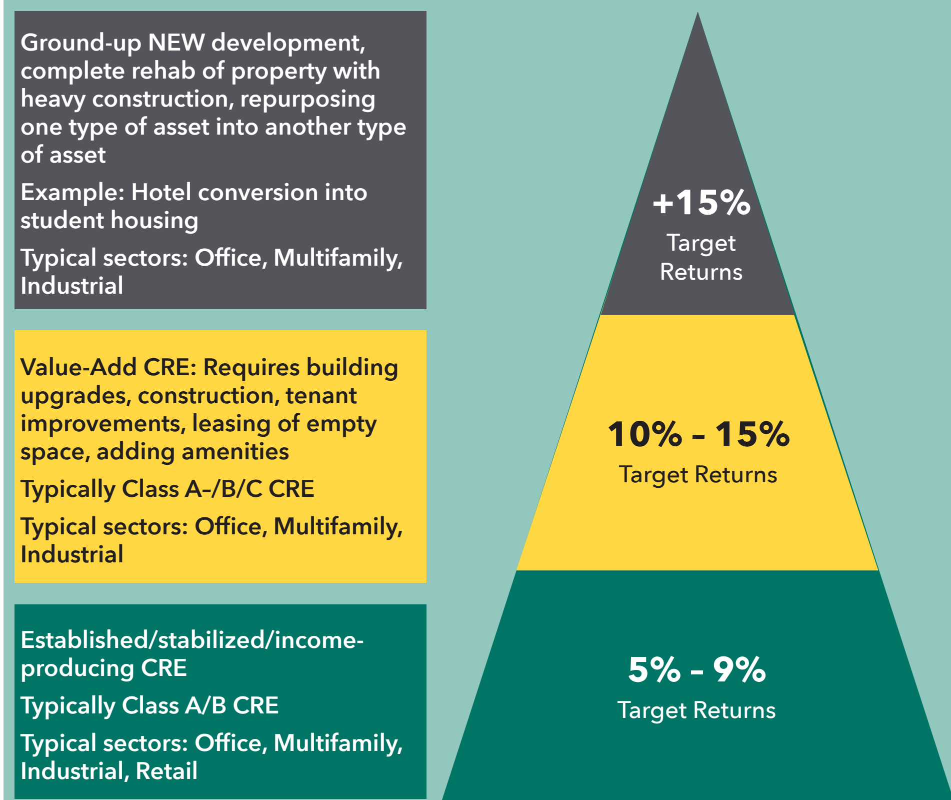

The pyramid is used to suggest that when building a CRE investment portfolio, a larger amount of capital is typically allocated to stabilized assets with existing and predictable cash flow. This provides a base to the CRE portfolio of both cash flow and some potential upside growth. The value-add strategy section of the portfolio will have a smaller allocation because it is taking on more risk than the base section, and the cash flow will not be as immediate. Finally, the smallest allocation is given to the riskiest tranche, which rarely provides cash flow in the early years but hopefully achieves a significant gain on exit.

A blend of the CRE pyramid tranches is a potential way to build a CRE investment portfolio. Before investing, evaluate the type of CRE asset, the sponsor, the location, the risk to cash flow and value, and the exit plan. Work with sponsors that provide total transparency and the ability for the adviser to gather as much information as possible on the investment options.

FOR MORE INFORMATION

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