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Non-Core Real Estate

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This paper examines the characteristics of non-core (value-added and opportunistic) real estate strategies and the impact of including them in an investor's portfolio. It concludes with a recommendation that investors should consider allocating part of their real estate allocation to non-core strategies.

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Introduction

The characteristics of non-core properties are quite different from those of core properties. The latter consists of high-quality assets that have high occupancy rates and provide steady cash flow. The investment profile of a core investment is like that of a bond, with reliable income streams and low volatility. These properties do not require significant enhancement, renovation, or development. In contrast, non-core strategies encompass greater risk through increased use of financial and operational leverage, greater reliance on renovation or development, a focus on secondary markets, and a number of other factors. In return for taking on greater risk, investors in non-core real estate strategies expect to be compensated via higher returns.

	Core	Core Plus	Value-Added	Opportunistic
Property Types Included	4 Majors*	4 Majors	4 + Limited Specialty	4 + Moderate Specialty
Occupancy at Acquisition	≥ 85%	≥ 85%	< 85%	< 85%
Target Markets	Primary	Primary	Primary/Secondary/ Tertiary	Primary/Secondary/ Tertiary
Asset Physical Needs	Minor	Light Upgrades	Renovation	Rehabilitation/ Development
Holding Period (years)	7 - 10	7 - 10	3 - 7	1 - 5
Income (as % of total return)	≥ 70%	≥ 70%	30% - 70%	< 30%
Leverage	0% - 40%	40% - 60%	60% - 75%	60% - 80%
Net Return Expectations	4% - 8%	5% - 10%	8% - 12%	10% +

FIGURE 1
Typical Core and Non-Core Real Estate Characteristics
Source: Meketa Investment Group.
Note: *As described in the appendix, these include office, retail, multifamily, and industrial properties. Specialty properties include hotel, storage, student housing and other smaller segments of the investable universe.

A comparison of core and non-core real estate characteristics is presented in Figure 1. These characteristics include the expected portfolio composition, occupancy, target markets, physical needs, holding periods, income expectations, leverage, and expected return.[1] Portfolio composition refers to the prospective types of properties. Occupancy at acquisition refers to the proportion of square footage occupied at purchase. Target markets refer to property location, such as primary (e.g., centralbusiness district) or secondary (e.g., suburban). Physical needs refer to the degree of repair required, ranging from repositioning (i.e., refurbishment and operational improvements) to development (i.e., ground up property construction).

[1] For some funds/strategies, the classification is not as discrete as presented in this table.

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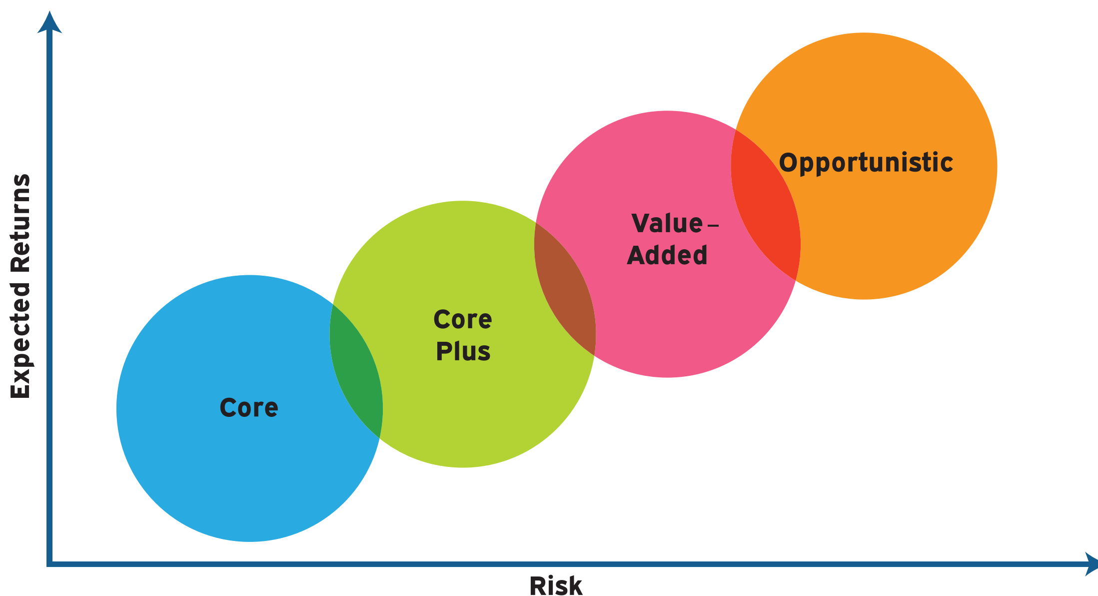

FIGURE 2

Risk/Return Expectations

Source: Meketa Investment Group.

Strategies

Non-core real estate strategies are usually put into one of two categories: value-added or opportunistic. Each offers unique characteristics, though there can be overlap between them.

Value-added

Value-added real estate offers a risk-return profile that is greater than that of core real estate, but less than that of opportunistic, as indicated in Figure 2. Compared to core, this strategy focuses more on capital appreciation through physical property enhancement processes: repositioning, renovation, lease-up and/or re-tenanting, and redevelopment. Repositioning generally involves refurbishment and enhanced property management, which allow for a potential "re-grade" of property quality and for increased revenue. Renovation can include property enlargement, completion of major capital improvements to upgrade quality (e.g., a new roof or lobby), or structural repair and refinishing. Redevelopment can include a major overhaul and conversion of a property for a different use (e.g., a warehouse converted to multifamily apartments).

Value-added funds will likely include a moderate income return component as opposed to opportunistic funds, which rely primarily on appreciation. Assets commonly include the four main property types (i.e., office, retail, multifamily, and industrial) along with investments in hotels and other specialty property types. Some value-added strategies may invest in markets outside of the United States, which adds the risks of currency fluctuation and differing legal frameworks. Leverage is typically limited to 65% loan-to-value, a higher level than core strategies but lower than opportunistic strategies. Most value-added fund vehicles are closed-ended, which means they can tie up investor capital for periods of 10 years or longer, though individual properties may be held for much shorter periods.

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Opportunistic

Opportunistic strategies offer the highest level of expected return and risk potential within real estate, as is shown in Figure 1. Most of the expected return depends on future appreciation, resulting from physical property enhancements or ground up development. Ground up development introduces distinct and significant risks, specifically, the uncertainty of permitting, on-time and on-budget construction, changing market conditions, and leasing. These risks influence the profitability of a development project and affect the developer's ability to purchase land, construct buildings, lease space to tenants, and to repay debt. However, some risk can be mitigated through various methods, such as pre-sales, purchasing land that is already entitled, and securing cost overrun guarantees from the developer.

Opportunistic asset types include the four main types along with hotels and other specialty property types. These specialty property types may include self-storage facilities, entertainment facilities, medical offices, life science facilities, senior housing, student housing, data storage, and more. Opportunistic fund leverage is typically moderate to high, with most fund-level limitations in the range of 60% to 80% loan-to-value. Fund vehicle types are almost exclusively closed-end since the investments are typically illiquid, difficult to price, and represent projects that can take years to execute.

Non-core performance

Figure 3 shows performance for both core and non-core real estate funds based on information provided directly by real estate managers. The data confirms that risk and return profiles of non-core funds vary significantly from those of core funds. The data also indicates that the dispersion of returns, as measured by the spread between top and bottom quartile funds (i.e., the inter-quartile spread), was modest for core funds but wide for value-add and opportunistic strategies. This is to be expected given the more concentrated approach, multiple risks, and the increasing difficulty to manage all the risks that are inherent in most value-add and opportunistic funds. This level of dispersion highlights that an investor's skill at selecting managers will have a big impact on the investor's experience in non-core real estate investing.

	Core (%)	Value-Added (%)	Opportunistic (%)
20-Year Annualized Return	7.2	8.2	7.7
20-Year Annualized Standard Deviation	6.7	10.3	10.1
5-Year Inter Quartile Spread	2.1	9.0	12.8

FIGURE 3

Real Estate Returns by Strategy

Returns are net of fees and on a time weighted basis. The source for core fund data is NCREIF NFI-ODCE Equal Weighted Index. Value-added and opportunistic fund data is provided by Preqin and may be biased due to survivorship and self-selection issues. Data is as of December 31, 2021.

The 20-year period shown in Figure 3 included several market cycles for commercial real estate. Non-core strategies have outperformed core, on average, but this oversimplifies the experience for many investors. Negative performance during and around the Global Financial Crisis ("GFC") cast a pall on non-core real estate strategies that still lingers in the minds of investors despite post-GFC outperformance. We expect

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non-core real estate will continue to be riskier in the future and expect investors to be compensated, on average for investing in riskier real estate assets while noting that much will depend on fund selection.

Property type considerations

Risk-reward characteristics vary by property type with the effects of these characteristics magnified by the strategy type pursued. For example, non-core real estate entails increased levels of leverage and property enhancement, both of which magnify volatility. This is especially true for higher risk, opportunistic development projects, which can involve significant leverage amounts, construction lead times and lease-up lead times.

FIGURE 4
Typical Property Type Characteristics
Source: Meketa Investment Group.

Property Type	Lease Duration	Historical Cyclicality	Construction Period (Months)	Other Characteristics
Multifamily	Annual or 6 months	Low	12 to 36	Government agencies are a reliable lender for residential properties; consistent demand; best historical risk-adjusted returns.
Retail	5 to 10 years	Moderate	12 to 48	Public REITs hold a large percentage of mall properties.
Industrial	5 to 10 years	Moderate	9 to 12+	Construction time is shortest of the main property types.
Office	5 to 10 years	High	18 to 48	Above average volatility; tenancy significantly impacted by economic downturns.
Hotel	Daily	High	12 to 24	Most volatile historical return series due to daily repricing of rental rates.

Lease agreements vary significantly for each property type (as indicated in Figure 4). Multifamily leases typically terminate annually or in periods of six months, while office, industrial and retail lease terms usually terminate after five to ten years. Annual leases are advantageous during upward-cycles, allowing higher rental rates to be charged sooner. Long-term leases, by contrast, can be beneficial if they extend an above-market rate through a downward cycle.

In addition to the base rent, long-term leases may include built-in adjustments such as step-ups after a certain period of time, inflation-related increases, and even percentages of a retail tenant's gross sales. These rent adjustments help long-term leases compensate for an inability to renew to market rents annually.

As indicated in Figure 4, construction periods can vary drastically from as short as nine months for certain industrial projects to as long as four years for complex office For numerous reasons, investor risk increases as construction periods increase. Principally, these risks are the possibility of increasing costs (e.g., financing, materials, labor) and greater uncertainty about the possible economic environment when construction is completed (i.e., can the property be leased at a rate sufficient to cover its costs?).

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Geography

The geographic placement of real estate can have a significant impact on its performance. An example of this is the historical trend of properties in primary markets outperforming those in secondary and tertiary markets. Primary markets typically include major metropolitan districts, such as New York City, Boston, Washington D.C., San Francisco, and Los Angeles. These markets have substantial employment sectors that create tenant demand that typically matches or exceeds available supply of real estate space (i.e., land). This limited supply of land, when matched with high demand, has led to higher market rental rates and occupancy rates historically.

Secondary and tertiary markets are typically suburban markets with fewer constraints on new supply and inconsistent demand for real estate space. Historically, in an economic down market, tenants tended to move toward primary markets (city centers) to take advantage of unusually attractive lease rates on prime property. This effect reduced the downside risk for primary markets. However, due to the COVID pandemic, the opposite scenario has happened, with people moving out of primary and secondary markets to tertiary ones. It is important to take this phenomenon into account and adjust to future trends as needed.

There are many other factors that affect local real estate markets, including: market demand influences such as job growth, the quality of job creation (indicated by salaries and wages), resident ages, sizes of households, availability of high-quality education and transportation networks, tax regimes, municipal health, and other related demographic information.

Global

Real estate funds with a global mandate tend to be focused on the developed economies of the United States, Western Europe, and Asia. The United States and Western Europe, along with certain Asian markets, represent mature regions for core, value-added, and opportunistic strategies. The emerging markets have generally less stable and less mature real estate markets that attract opportunistic strategies. Differing legal and political systems permeate these regions, so local expertise is paramount for any investment outside the US.

Supply and demand

Developers must carefully consider job growth, salaries and wages, ages and size of households, and financing costs when determining the economic benefits of undertaking a project. The supply of space available in a market tends to stay fixed in the short term and requires significant lead time to adjust to increases in demand. Thus, under-development or over-development can have a prolonged effect on market fundamentals (i.e., rent, occupancy, and absorption rates). Additionally, developers must consider market values in relation to replacement cost, which is the total cost to build

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or replace a property. If the property replacement cost is greater than the expected market value, it is not sensible for a developer to undertake the project.

Supply and demand information will help a manager determine which markets are most likely to benefit from economic growth. The positive supply and demand characteristics of densely populated primary markets had given them a structural advantage in producing returns historically. Importantly, we expect significantly less volatility in real estate supply and demand than historically because there is much better data available to developers and investors (even though the markets are still inefficient, relatively speaking).

Real estate fundamentals

The "fundamentals" of real estate have a significant effect on performance. Real estate fundamentals include rental rate, occupancy rate, absorption rate, and capitalization rate. Rental rate refers to the amount tenants are willing to pay for space (price per square foot). This is affected by property size and quality, lease duration, and most importantly, market conditions. Occupancy rate refers to the amount of space, as a percentage of the property, that is currently occupied. Absorption rate refers to the rate at which real estate vacancies are either leased or sold to users in the marketplace, usually expressed as square footage per year.

Perhaps the most important (and most transparent) metric for the real estate market is the capitalization rate. The capitalization rate could be viewed as the inverse of a price-earnings ratio as it is calculated by dividing the annual net operating income by the property purchase price. A higher capitalization rate indicates a higher expected (or required) return on investment. Capitalization rates are significantly affected by general market conditions (e.g., they tend to increase as prospects for property fundamentals deteriorate). These rates vary by property type and by market, indicating differences in risk/reward ratios. For example, the more volatile office and retail sectors generally trade at above-average capitalization rates, as do properties in tertiary markets.

Historically, real estate returns have been linked to capitalization rates. As with any investment, the price paid for future cash flow has a meaningful effect on returns. Figure 5 portrays how higher (or downward trending) capitalization rates have preceded stronger returns and vice versa. However, shorter-term returns can be affected by events such as the GFC and COVID pandemic.

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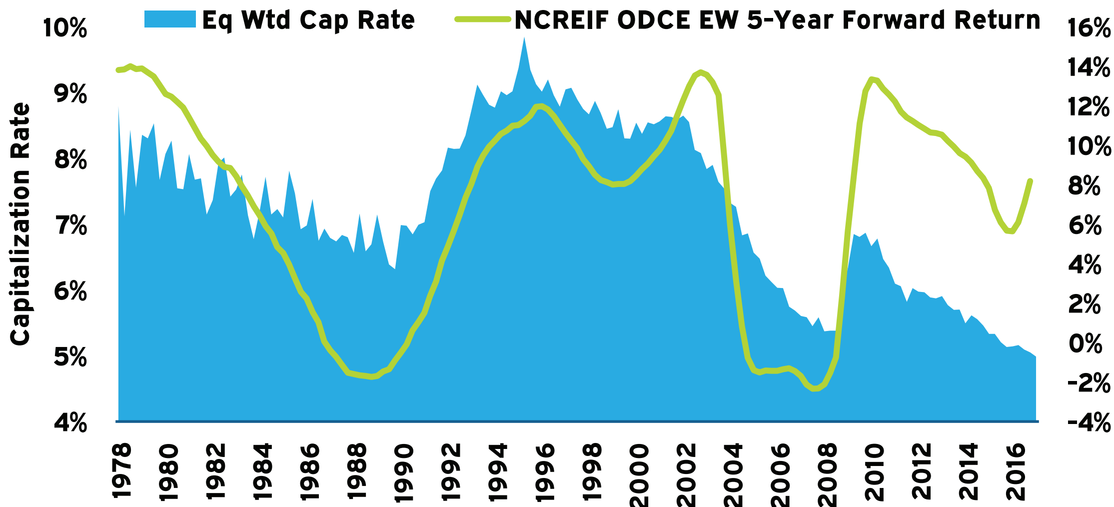

FIGURE 5

Impact of ODCE Cap Rates on Future Returns

Source: NCREIF.

Financing and leverage

Real estate is a capital-intensive asset class. Debt allows a real estate manager to gain greater real estate investment exposure with the same amount of equity capital. The effect of this is an amplified positive or negative return on equity. Positive leverage occurs when the property's unlevered return is greater than the interest rate on the debt. Otherwise, negative leverage will occur, causing a magnified loss of equity. Thus, leverage has a "swing" effect on performance.

The amount of debt, as a percentage of property value, is termed loan-to-value (LTV). Higher LTVs, such as 80% or higher, increase the risk of foreclosure, as the equity cushion between debt and the property value is smaller. Loans at higher LTVs are generally at higher interest rates and are more difficult to obtain, depending on the market environment. An important alternate measure of leverage is the debt service coverage ratio (DSCR), which describes how many times cash flow from an asset can cover current debt obligations. Core properties typically have a DSCR of at least 2.0 times. Unlike LTV, the DSCR is not influenced by volatility in the asset's value, which can be significant during times of market dislocation.

Role in portfolio

The primary reasons for investing in non-core real estate are to increase diversification and to enhance potential returns. Similar to private equity investments, non-core investments may offer a higher expected return, along with higher risks, and manager selection and skill are paramount.

Non-core real estate strategies often incorporate specialty property types and additional geographies, which allow for enhanced diversification. Further, historically they have exhibited low-to-moderate *observed* correlations with the public equity

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and debt markets and, at the same time, low *observed* volatility.[2] Still, these strategies should be considered at least as risky as public equities. However, we expect that an allocation to non-core real estate, if funded from equities, should *decrease* the expected risk of the overall portfolio, as shown in Figure 6.

[2] This observed volatility and correlations are artificially lowered by the historical accounting and pricing methods used by private real estate firms (i.e., they are marked to market on a quarterly or annual basis, and they use transaction-based appraisals).

	Without Non-Core	With Non-Core
Core Real Estate	5%	5%
Non Core Real Estate	0	5
Global Equities	60	55
High Quality Bonds	35	35
Expected Return	*5.8*	*5.9*
Expected Standard Deviation	*11.2*	*11.0*

FIGURE 6

Impact of Adding Non-Core Real Estate on a Multi-Asset Class Portfolio

Source: Meketa's 2022 20-Year Capital Markets Expectations

Other considerations

When constructing a portfolio of real estate investments, an investor should seek to diversify the portfolio broadly, both in core and non-core assets. This includes diversification by strategy, geography, property type, employment base, manager, vehicle, individual investment, and vintage year.

An investor in non -core real estate should also consider vehicle types, the J-curve effect, governance, alignment of interests, valuation methods, market cycles, labor concerns, use of third-party property management, financing, supply and demand factors, and liquidity. The materiality of each of these risks varies. However, non-core investing involves the layering on of multiple of these risks, resulting in a multiplicative (versus additive) increase in risk, for which the investor must believe they are being compensated.

Vehicle type, J-curve effect, and valuation

Non-core funds are generally available only in closed-end vehicles. A closed-end fund does not offer capital withdrawal during its fund term, which may extend beyond 10 years.

In the first three to five years, a phenomenon known as the "J-curve" effect occurs whereby returns will likely be negative or low. This is because fees are charged and capital is spent on property enhancement or development, but the property does not necessarily produce income immediately and increases in value occur later in the fund life. An example of this is a development project that is substantially complete, and the property is expected to be worth much more as a finished product. A meaningful realization of appreciation is often captured at a later stage when the project is fully complete and stabilized (i.e., leased). Thus, during the J-curve period, the total return may appear negative even though a significant amount of capital has been deployed, and the appraised value may not accurately reflect the project's true worth.

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Commitments and pacing

Most non-core real estate funds require an advance commitment of capital. The commitment is drawn down, or "called," by the general partner typically over a period of two to five years. During this period, other partnerships owned by an investor may be in their distribution phase, effectively reducing the investor's allocation to real estate. Therefore, to maintain a fixed level of actual investment in real estate, it is generally necessary to commit more than the target allocation (i.e., over-commit).

The year in which a partnership makes its first investment is known as its "vintage year." Depending upon macroeconomic events and available opportunities, some vintage years have better performance than others. Therefore, it is often beneficial to structure investments to provide for diversification across multiple vintage years.

The universe of funds

The construction of a real estate portfolio will be partly determined by the available set of investment opportunities. Because there is no universal database to which all non-core funds report, it is impossible to know the precise size of the universe of funds. An estimate of the size and scale of the universe or real estate funds is shown in Figure 7.

	Value-Added	Opportunistic
Funds	327	245
Gross AUM	$14 bn	$20 bn

FIGURE 7

Real Estate Fund Universe

Source: The source for all funds is Preqin. Represents funds incepted in 2021 and 1H2022, as of July 2022.

As shown in Figure 7, from 2021 to 2022, 245 opportunistic funds have successfully raised $20 billion in capital. Over the same period, 327 value-added funds raised $14 billion in capital. Further, it can be reasonably assumed that not all funds are included in this database.

Labor

Labor policies are more relevant for non-core real estate strategies as labor relations can be very important for projects that involve construction and renovation. Some managers have defined a firm-wide Responsible Contractor Policy,[3] which states their basic philosophy when dealing with labor- and union-related issues. It is advantageous to obtain case studies and references that highlight the manager's activities relating to the policy. Having such practices in-place can help an investor determine if the manager adheres to a labor-friendly policy.

[3] A Responsible Contractors Policy (RCP) is designed to guide the selection of independent contractors and subcontractors who provide construction, repairs, maintenance, and infrastructure operating services. Among the guiding factors outlined in a policy are compliance with applicable statutes and payment of "fair" compensation and benefits to employees.

Third-party servicers

Property maintenance and other services such as leasing can be performed by either an in-house group or a third party. The choice of these providers can have a significant impact on property performance. While some value-added strategies utilize in-house property managers, most opportunistic strategies use third-party property managers. This occurs because opportunistic strategies mostly focus on property improvement followed by a sale, instead of holding property on a long-term basis.

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There are certain considerations that surround in-house property management and third-party property management. For instance, in-house property management includes an internal management fee that is typically charged back to the fund. Investors should expect this fee to be charged at a fair market rate and should monitor any conflict that this secondary source of income for the manager could create. For example, in-house management could influence the manager to inappropriately retain or acquire properties that generate property management revenues. On the other hand, in-house management brings a valuable ability to directly oversee and control properties in the portfolio.

The use of third-party property management has different drawbacks such as reducing direct management oversight. However, third-party managers are often regionally specialized and local to the property, which may bring a better understanding of the market. Using third-party property managers also reduces the need to adjust the amount of personnel as properties are bought and sold. Additionally, using third-party property management allows for better managers for each specific region or micro-market to be selected.

Market cycles

The cyclical nature of the real estate industry can have a significant impact on non-core real estate performance. Purchasing non-core real estate during market downturns can be particularly profitable as non-core strategies have amplified cycles. This can allow a manager to purchase property at discounted prices and then complete physical renovations followed by selling at a higher price if market valuations revert.

Conversely, purchasing non-core real estate near a market peak can have a correspondingly bad outcome. Figure 8 portrays boom and bust periods for commercial real estate. It is worth noting that the amplitude of these cycles would likely be greater for non-core real estate, which tends to use more leverage.

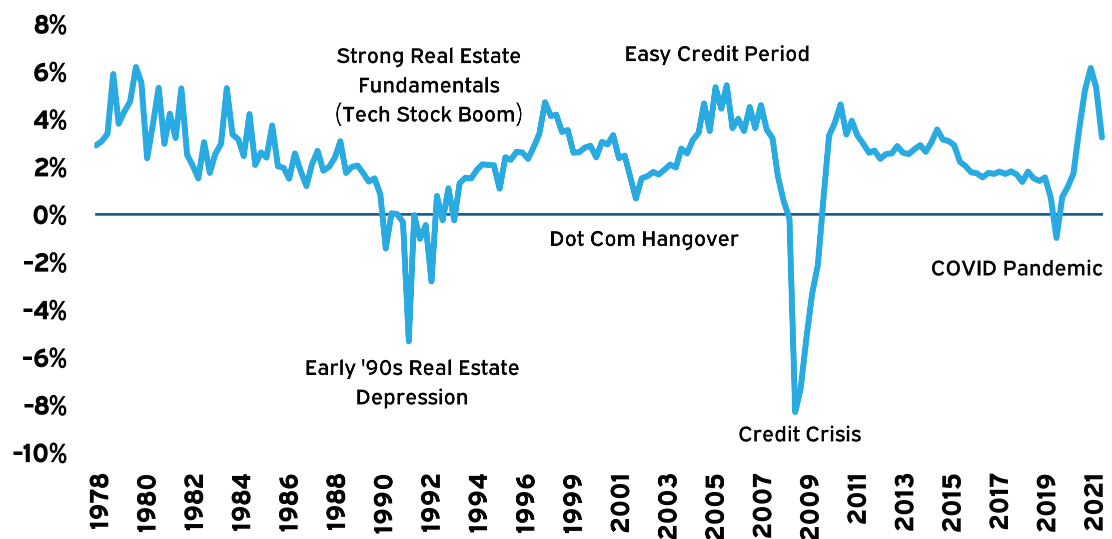

FIGURE 8

NPI Quarterly Returns - Institutional Grade Real Estate

Source: NCREIF NPI Details 2022.

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There are additional downside risks involved with market cycles, including leasing risk, financing risk, and market timing risk. Leasing risk entails the difficulty of finding tenants after renovations or development have been completed. Aggressive terms (e.g., discounted rents, concessions, etc.) may be necessary to lease the property, causing a reduction of income, which, in turn, reduces property value. Financial risk can occur from tighter underwriting standards, which restrict availability of loans to purchase or re-finance real estate. In the most extreme cases – when a property is highly indebted – it can result in the inability to make debt payments and potentially foreclosure on the property. Financial risk can also occur from *looser* underwriting standards as experienced during the GFC when large loans with light or no covenants, cross collateralization and recourse provisions were extended against assets with low debt service coverage ratios that quickly became impaired. Lastly, if a downward market occurs during the life of a non-core fund, the managers may find it necessary to hold onto properties longer than originally planned.

Costs

Total expected costs and fees associated with non-core real estate investing are higher than for core real estate. There are three essential types of fees associated with non-core real estate funds. The first is a management fee, which typically ranges from 1.25% to 2.0% per year. The second is a performance fee, typically called "carried interest," which is paid as percentage of fund profits if a certain hurdle, or "preferred" rate of return, is achieved. Once the general partner has produced a minimal baseline return for the limited partners (called the "hurdle rate"), all future profits are usually divided between the general partner and the limited partner (called "carried interest"). For example, a partnership may specify a hurdle rate of 8% and a carried interest of 20%. This means that as soon as the limited partners have received a return of 8% on their initial investment, 20% of all profits are distributed to the general partner and 80% to the limited partners. Finally, a general partner may also take an acquisition fee once a property has been purchased and a disposition fee once an asset has been successfully sold, though this is increasingly rare.

Joint venture partnerships

Real estate managers often create joint venture partnerships in which two or more parties acquire or develop a real estate property. Usually, joint ventures involve a real estate fund manager (limited partner) who needs a developer or operator as a general partner. These partnerships often require that the limited partner contributes a substantial amount of capital, while the general partner is expected to assume full responsibility for the deal execution process. The general partner's performance is typically rewarded by a performance fee, that is calculated as a percentage of profit (i.e., carried interest) after a return hurdle (i.e., preferred return) has been met. For example, in a joint venture partnership, an operator or developer could receive a 20% carried interest after a 9% preferred return is achieved by the fund on the property.

While some value-added strategies use joint venture partnerships, nearly all opportunistic strategies use them. It should be noted that using joint venture partners can incur increased costs that are not explicitly charged as management fees and are not readily visible to the investor.

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Benchmarking

The NCREIF ODCE index is the standard for benchmarking institutional core real estate. However, this index does not account for the risk premium one would expect to receive investing in non-core real estate. Hence it is common for institutional investors to add a premium on top of the ODCE to account for the additional risks being taken in a non-core portfolio.

Time and liquidity

An allocation to non-core real estate will often require added commitments by the investor in time and resources. Administratively, the capital calls and distributions associated with non-core real estate funds are unpredictable. Fund administrators need procedures to accommodate these cash flows reliably and efficiently. Moreover, these assets will require additional monitoring by the investor and their investment advisor.[4]

[4] For example, some investors use dedicated real estate advisors to oversee or assist with their real estate program.

Any meaningful commitment to private markets requires that an investor have a good handle on their overall liquidity. This is particularly true as the size and risk level of their non-core investments increase.

Summary and recommendation

There are potential advantages to investing in non-core real estate, principally, the opportunity for enhanced returns and diversification. Still, there are disadvantages of non-core real estate, including higher risk as well as the diminished transparency and liquidity that accompany private market investments. On balance, however, an allocation to non-core real estate should benefit most long-term portfolios. Non-core strategies comprise a large portion of the investable real estate universe and offer additional sources of return relative to public markets that stem from control of the assets. Managers can develop properties, improve properties, and at times of distress, acquire them at depressed prices.

For investors who already have core real estate investments, non-core real estate can enhance total return, albeit with a meaningful increase in risk. Meketa Investment Group recommends that most investors consider allocating between 30% and 60% of their real estate portfolio to non-core strategies. The target allocation will depend primarily upon the investor's risk tolerance and objectives for their overall portfolio. We recommend building a diversified (by asset type, life-cycle, geography, etc.) sub-portfolio of non-core funds over a period of three to six years. Finally, investors should be aware that market cyclicality will play a large role in the returns these vehicles produce.

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Appendix A | Glossary of real estate terms

Absorption | The amount of inventory or units of a specific commercial property type that become occupied during a specified time period (usually a year) in a given market, typically reported as the absorption rate.

Appraisal | An estimate of a property's fair market value that is typically based on replacement cost, discounted cash flow analysis, and/or comparable sales price.

Asset management | The various disciplines involved with managing real property assets from the time of investment through the time of disposition, including acquisition, management, leasing, operational/ financial reporting, appraisals, audits, market review and asset disposition plans.

Base rent | A set amount used as a minimum rent with provisions for increasing the rent over the term of the lease.

Broker | A person who acts as an intermediary between two or more parties in connection with a transaction.

Capitalization rate | A percentage that relates the value of an income-producing property to its future income, expressed as net operating income divided by purchase price. This is also referred to as *cap rate.*

Capital structure | The structure for financing a commercial real estate property or portfolio. Commercial real estate capital structures typically include equity and senior debt, which represent capital from an investor and the first position mortgage. Mezzanine debt, construction loans, and participating debt may also be included, which are additional forms of filling in needed capital for a capital structure.

Central business district (CBD) | The downtown area of a city, usually the location of a concentration of high-rise office buildings and commercial activity.

Closed-end fund | A commingled fund that has a targeted range of investor capital and a finite life.

Concessions | Cash or cash equivalents expended by the landlord in the form of rental abatement, additional tenant finish allowance, moving expenses, or other monies expended to influence or persuade a tenant to sign a lease.

Construction loan | Interim financing provided to support the developmental phase of a property.

Development | Ground up property construction. It can generally be broken down into specific categories: *economic development, site selection, and commercial, industrial or residential* real estate projects, all of which are either directly or indirectly related to *startups, expansions or relocations. Real estate development* in sophisticated *locations* is guided by controls and restrictions. They are usually identified by names as residential developments and business, office, commercial, or industrial parks or buildings. A *planned community* is a type of real estate development.

Improvements | In the context of leasing, the term typically refers to the improvements made to or inside a building but may include any permanent structure or other development such as a street, sidewalk, utilities, etc.

Internal rate of return (IRR) | The percentage rate earned on each dollar that remains in an investment each year. The IRR of an investment is the discount rate at which the sum of the present value of future cash flows equals the initial capital investment.

Joint venture | The joining of two or more individuals or entities in a specific business enterprise such as the development of a project or the acquisition of an investment.

Lease | An agreement whereby the owner of real property gives the right of possession to another for a specified period of time and for a specified consideration.

Lease rate | The period rental payment to a lessor for the use of assets. It may also be considered as the implicit interest rate in minimum lease payments.

Leverage | The use of credit to finance a portion of the costs of purchasing or developing a real estate investment. Positive leverage occurs when the interest rate is lower than the capitalization rate or projected internal rate of return. Negative leverage occurs when the current return on equity is diminished by the employment of debt.

Lifecycle | The various developmental stages of a property: pre-development, development, leasing, operating and redevelopment (or rehab).

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Mezzanine debt | Somewhere between equity and debt. Mezzanine capital is that piece of the capital structure that has senior debt (or a first mortgage) above it (up to about 50 or 60 percent of value) and equity below it (about 15 to 30 percent). Usually, it has an LTV ratio of 70 to 85 percent. There is both equity and debt mezzanine financing, and it can be done at the asset level, entity, or company level or it could be unrated tranches of commercial mortgage-backed securities (CMBS). Returns are generally in the mid- to high-teens. Cycle considerations are very key (if values drop, the mezzanine position can be wiped out) as is real estate due diligence.

Net operating income (NOI) | The potential rental income plus other income, less vacancy, credit losses, and operating expenses.

Open-end fund | A commingled fund that does not have a finite life. It continually accepts new investor capital and makes new property investments.

Opportunistic | A phrase generally used by advisers and managers to describe investments in underperforming, undermanaged or new (construction) assets that hold the expectation of near-term increases in cash flow and value. Opportunistic investments typically involve a high degree of risk and hence seek higher returns.

Property management | The day-to-day management, often on-site, of the operations of a property including rent collection, tenant services, care of the physical plant, security, and adherence to regulatory requirements. Some property management arrangements also include lease renewal negotiations and even the leasing and marketing of the property to outside prospects.

Real estate investment trust (REIT) | An investment vehicle in which investors purchase certificates of ownership in the trust, which in turn invests the money in real property and then distributes any profits to the investors. The trust is not subject to corporate income tax as long as it complies with the tax requirements for a REIT.

Rehabilitation | Extensive renovation intended to cure obsolescence of a building or project.

Renovation | The state of being restored to its former good condition; "the inn was a renovation of a Colonial house."

Self-selection bias | Refers to the fact that fund managers have the choice to report their returns to an index. Most managers will report only if they feel their performance numbers are above average.

Submarket | A segment or portion of a larger geographic market defined and identified on the basis of one or more attributes that distinguish it from other submarkets or locations.

Survivorship bias | Refers to the fact that only managers that stop reporting performance data are removed from an index. The most common reason for not reporting is poor performance.

Vacancy | The number of units or space (of a specific commercial type) that are vacant and available for occupancy at a particular point in time within a given market (usually expressed as a vacancy rate).

Vacancy rate | The percentage of the total supply of units or space of a specific commercial type that is vacant and available for occupancy at a particular point in time within a given market.

Value-added | A phrase generally used by advisers and managers to describe investments in underperforming and/or undermanaged assets, but that excludes ground-up development.

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Property type descriptions

Real estate varies significantly, not only among property types *but within* property type sectors. An example of this is high-rise compared to low-rise office buildings, both of which entail considerably different characteristics. As such, it is important to monitor real estate portfolio exposures at a fairly granular level. Below are descriptions for the main asset types, each of which contains numerous subsets.

Multifamily | Usually differentiated by location (urban or suburban) and size of structure (high-rise, low-rise, or garden apartments). High-rises are normally found near or in central business districts of cities as land costs are greater than in suburban areas.

Industrial | Often used for "last mile" e-commerce fulfillment, manufacturing as well as for warehouse space. The category also includes special purpose buildings such as those used by wholesale distributers and combinations of warehouse, showroom, and office facilities.

Retail | Varies from large regional shopping centers to strip centers. It is also common to find retail space on the first floor of office buildings in major cities.

Office | A commercial property type used to maintain or occupy professional or business offices. Properties vary from large multi-tenant buildings in major cities to single tenant buildings in suburbs.

Hotel | Hospitality real estate driven by both leisure and business travel. Investments are generally categorized by the level of service and amenities at the property and depends highly on property management execution.

Other specialty | Self-storage facilities, medical offices, senior housing, student housing, casinos, land, and other niche real estate.

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