Real Estate Investment: A Strategic Approach
Fourth Edition, 2023

Andrew Baum

Chapter One

Real Estate – the Asset Class

Real property/real estate

- Property is that which is capable of belonging to somebody
- Real property and personal property are the two main subunits of property in English common law
- In English common law, real property, real estate, realty, or immovable property is land and the improvements made to it: usually, buildings
- French-based law (Roman law) calls it “immobilier” (immovable)
- “Property is theft” (Proudhon)

Real estate investing

London's 30 St Mary Axe – The Gherkin - was sold in 2014 for £710m.

The top rents for the space (total 470,000 sq ft) are around £60 psf.

Total rents passing are believed to be around £24m. The anchor tenant of the 40-floor building is Swiss Re.

It was acquired by the Brazil-based Safra Group. A good deal?

Real assets

- Real assets is an investment asset class that covers investments in physical assets such as real estate, energy, and infrastructure
- Real assets have an inherent or intrinsic physical worth (replacement cost)
- Real assets differ from financial assets (securities) in that financial assets get their value from a contractual right and are typically intangible
- These investments are **asset backed**: this may be land, or land plus improvements (structures)

Real estate is the world's largest and most important asset class. All the property in the world, including commercial and residential property, is worth an estimated **$280 trillion** (Savills, 2019).

The value of all the gold ever mined throughout history is a mere US$7.5 trillion (World Gold Council, 2017).

As the world's largest asset class, real estate exceeds the total value of all stocks, shares and securitised debt combined. It is about 2.3 times the value of outstanding securitised debt (~$100tn), and 3.3 times the total value of equities (~$70tn).

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The capital stock (US$, trillion)

	UK	%	US	%
Housing	4.45	65%	19.71	41%
Commercial property	0.77	11%	15.56	32%
Infrastructure	0.91	13%	6.49	13%
Plant and machinery	0.74	11%	6.65	14%
	6.87		48.41	
Source: OECD				

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Real assets: the ultimate **Impact** asset class.

It serves the human need for shelter and creates the places we live and work

Facebook launches $1B affordable housing initiative, joining tech peers trying to close the gap

BY MONICA NICKELSBURG on October 22, 2019 at 1:25 pm

* Source: JLL (08/17)
** Local Government Association Local Government Funding Report 2018

- Over 1.1 million households currently on the social housing waiting list
- New homes: prolonged supply/demand gap of 100,000+ per annum
- Renters pay on average 65% of disposable income in London

- +8.6 million people aged 65 and over in 50 years time
- 1.4 million older people do not have access to required care
- £1.2 trillion of UK housing stock held by the over 65s by 2021*

- Failing town centres: High street vacancy at 24%
- Local government services face £7.8bn funding gap by 2025**

- Built environment responsible for 40%+ of global carbon emissions
- Huge task of meeting Paris Agreement climate change commitments

CHEYNE CAPITAL LAUNCHES A UK IMPACT FUND

Cheyne Capital has launched a new impact real estate fund with an initial £150 million to invest in affordable housing and supported living facilities in the UK. The open-ended Cheyne Impact Real Estate Trust will work with a mixture of councils, housing associations and charities from across the UK to provide affordable and keyworker housing, supported living facilities, care provision and mixed tenure developments. The impact fund follows Cheyne Capital's Social Property Impact Fund which was launched in 2014 to help tackle the chronic shortage of housing for disadvantaged groups in the UK.

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Real estate: personal, corporate, investment

- Personal asset: home ownership
  - Will this change?
- Corporate asset
  - Factor of production
  - Google at Kings Cross
- Investment asset
  - Pension funds
  - Sovereign wealth funds
  - Family offices and HNW

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Google: lease, buy or build?

Mega forces

- Sustainability and climate change
- Globalisation
- Demographics
- Urbanisation and density
- Health
- Social impact
- Technology

The Guardian: A £30bn British pension fund has threatened to sack investment managers that do not take action on the **climate crisis**, criticising the sector as “not fit for purpose”.

Brunel Pension Partnership, which manages pension money for nine councils in south-west England as well as for the **Environment Agency**, said it would review the mandates of asset managers that don’t reduce exposure to climate risk by 2022. The Bristol-based pension fund will demand that companies in which it invests take steps to align their emissions with targets agreed at the 2015 Paris climate summit. Brunel will vote against the reappointment of board members of companies that who are not doing enough and could also sell its stakes from 2022 onwards.

https://www.theguardian.com/business/2020/jan/27/30bn-pension-fund-well-sack-asset-managers-that-ignore-climate-crisis

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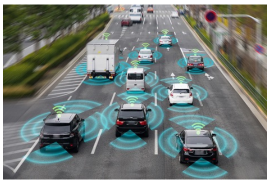
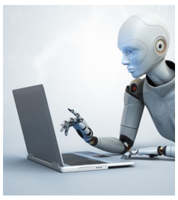
Things are changing…





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…is real estate about to catch up?


19th century | today


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Investment: a global asset class

- Mainstream asset – stocks, bonds, real estate (Type A)
- Alternative private asset – PE, hedge, real assets (Type B)

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What makes real estate attractive

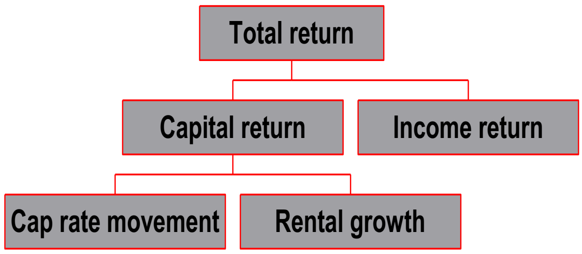
- It offers a reasonable return
- Return is mainly delivered through income
- Income is secure and stable (contractual, a prior charge)
- It is a real asset and a store of material value
- It offers low volatility (private markets)
- It diversifies a securities-based portfolio
- It offers an inflation hedge

- (Type A or B?)

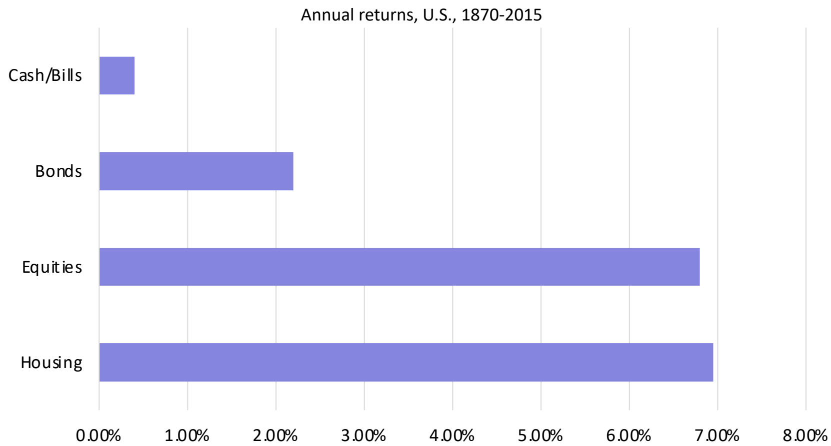
Total return: the formulae

- Income return = $Y_{0\text{-}1}$/CV0
- Capital return is the change in value over the measurement period divided by the value at beginning of the period
- CR = $[CV_1 - CV_0]/CV_0$
- Total return is the sum of income return and capital return
- TR = $[Y_{0\text{-}1} + CV_1 - CV_0]/CV_0$

Components of total return

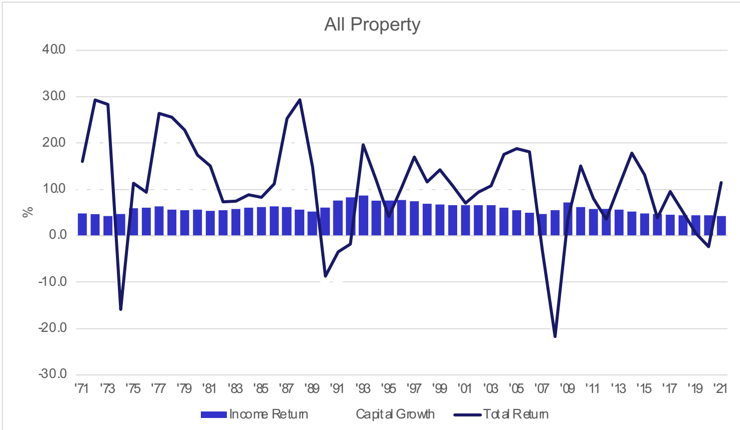


Strong returns – for less risk?



Source: NBER, 2017

Reasonable returns (UK, 1981-2021)



Source: MSCI, Baum, 2022

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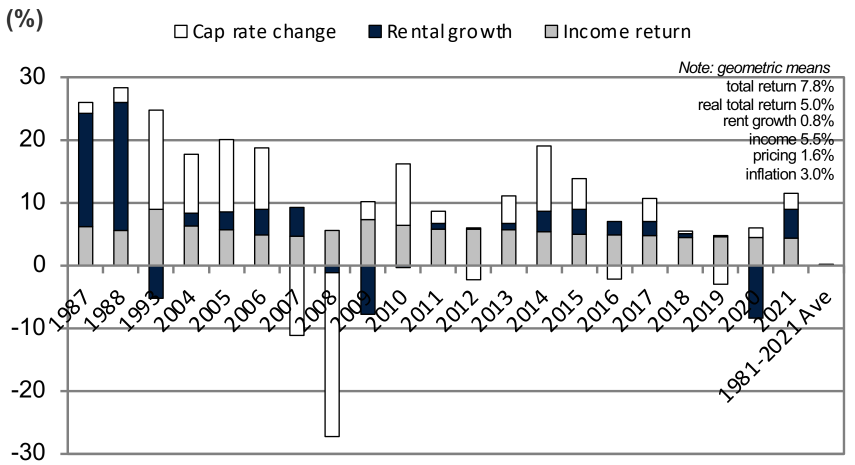
Reasonable returns (UK, 1981-2021)



Source: MSCI, Baum and Hartzell, 2020

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What makes real estate unattractive?

- It is illiquid
- It is lumpy and it is difficult to build a diversified portfolio
- It depreciates
- It is expensive to manage
- It is easily taxed

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Real estate is illiquid

- Direct trading costs
  - Buyers' taxes, survey fees, valuation fees, legal fees
  - Sellers' legal fees, brokers' fees
- 'Bid-offer spread' inhibits liquidity
  - 'Round trip' purchase and sale cost say 6.25%
  - Property bought for $1m - need to get back $1.0625m
  - Liquidity positively related to capital growth
- Indirect costs of transacting property
  - Time and effort on research
  - Risky process - abortive expenditure
- Lack of a formal market clearing mechanism for property

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Lots of capital is needed to diversify

Capital required (£m) Segment	5% tracking error	4% tracking error	3% tracking error	2% tracking error
Standard shops	28	42	74	157
Retail warehouses	86	129	259	1,013
Shopping centres	118	158	237	434
Other retail	40	60	100	169
London offices	152	243	455	1,229
South East offices	36	50	86	172
Provincial offices	36	58	87	166
Office parks	40	60	110	210
Industrials	32	51	90	212
All real estate assets	?	?	?	?

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How do you prefer to invest in real estate?

- Buy buildings or land directly?
- Joint ventures?
- Clubs?
- Listed securities?
- Funds?
- Funds of funds?

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Why do you prefer buildings/direct?

- You are better than professionals at stock selection
- You don't trust advisers
- You don't like paying fees
- You don't believe in the benefits of diversification
  - (Markowitz should give back his Nobel prize)
- You don't want to go through KYC or money laundering checks
- You have unique tax-based structuring issues
- You have at least $500bn of investable assets
  - (10% into real estate means you have $50bn to invest – enough to diversify)