How strategic is asset management of institutional real estate investors?

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Abstract

In many European countries, government withdrawal from the housing market forces social landlords to act more and more like commercial real estate investors. As a consequence, there is a growing need among social landlords for a rationalised, financially sound real estate management. In this respect, commercial real estate investors, facing financial and market pressure for a long time, may be expected to be far ahead. From this commercial experience, we have investigated how real estate investors in the Netherlands decide about the physical and technical development and the tenure of their housing stock. The paper deals primarily with asset management, and also with the impact of portfolio management on asset management. Results show that investment allocations are only partly rationalised and are based in part on intuition. Although there may be good reasons for that, it leaves a lot of room for a more professional management.

Introduction

Housing management in Western Europe is changing in response to developments in its political and economic context. Western European housing systems are in transition, as a part of a more general trend towards privatisation, deregulation and decentralisation of public tasks. Government support and direct object subsidies have been diminished (Boelhouwer, 1999; Smith and Oxley, 1997) These changes mean that landlords are less bound by specific regulations and have to be or to become financially more self-reliant. Although this concerns the social rented sector in particular, it also affects the private rented sector. In addition to the changes in the political context, housing markets are changing from a general shortage to an equilibrium and even to an over-supply in some sub-markets (Priemus et al., 1999).

Financial self-sufficiency and market developments affect stock management in several ways. In general, there is a clear tendency towards a more business-like and more systematic approach. The importance of financial and economic considerations in decision-making has grown. Awareness of market developments and market constraints has become a necessity. This can be seen in approaches and methods such as ‘strategic business planning’, ‘portfolio analysis’, ‘benchmarking’ and ‘balanced score cards', which are used to evaluate the performance of organisation and assets and to help develop management policy.[1]

Private, commercial investors have faced financial and market pressures for a long time. In addition, the importance of rationalised, transparent strategies has increased, not only in the social sector, but also in the commercial sector. This holds true in particular for larger, mostly institutional real estate investors, like pension funds and insurance companies. So we could expect business-like approaches and systematic techniques to be quite common for these real estate investors. To see whether this expectation is true, we interviewed 10 real estate investors. (We also interviewed 11 housing associations, but they are not subject of this paper.) We searched for the ways in which these landlords develop strategies for the management of their housing stock. We looked at the process followed, the strategies formulated and the methods and instruments used. This paper discusses the results of our research. In order to define the strategies and methods to be investigated, we have used the characteristics of 'strategic asset management', a concept developed some years ago by Van den Broeke (1998) on the basis of marketing theory and strategic planning, and applied by him to housing management. Using these characteristics - namely strategic, market oriented, comprehensive and systematic - we have developed our research questions:

[1] Similar developments in the United Kingdom and Germany are described in e.g. Walker and Smith (1999) and Pelzl (1999).

- To what extent do institutional real estate investors use business-like approaches and systematic techniques in their asset management of the housing portfolio?
- To what extent can the asset management of institutional real estate investors in housing be called ‘strategic’, ‘market oriented’, ‘comprehensive’ and ‘systematic’?
- What are the opportunities for further development of strategic asset management by real estate investors?

The structure of this paper is as follows. First, we will give a short description of the Dutch commercial housing sector, focussing in particular on the type of landlords in our research, namely real estate investors. Then, we go into some central terms in this paper, namely ‘asset management’ and ‘strategic’. In this context we discuss the characteristics of strategic asset management. After this, we discuss the research approach. Next, the results of our research are presented. The paper ends with a conclusion about the asset management of Dutch real estate investors and with some recommendations for practice.

Overview of private rented sector

In the Netherlands, the private rented sector consists of approximately 800,000 dwellings, which is about 11% of the total housing stock (Ministry of VROM, 2002). The private landlords may be divided into two categories (Priemus, 1998, p. 255):

- (institutional) real estate investors (mainly pension funds and insurance companies);
- individual private landlords.

Individual private landlords usually have a small number of properties. On the other hand, real estate investors own many properties, mainly concentrated in estates. These estates can be found all over the country, but there is a concentration in larger cities and densely populated regions in the western part of the country. We expect strategic asset management to be especially relevant to larger landlords. For this reason, we have focussed our research on institutional real estate investors.

Table 1 summarises some of the characteristics of the Dutch real estate investors. To compare, we also present some figures concerning Dutch housing associations, which possess 99% of all social rented dwellings in that country. As we can see, the total housing stock of the social landlords by far exceeds the stock of the real estate investors. On the other hand, the average size of the investors' housing stock is almost three times as big as the associations' stock. This can affect their stock policy, since, generally speaking, a rationalised strategic policy is especially relevant to larger landlords.

Table 1 *Properties of Dutch real estate investors in 2001*

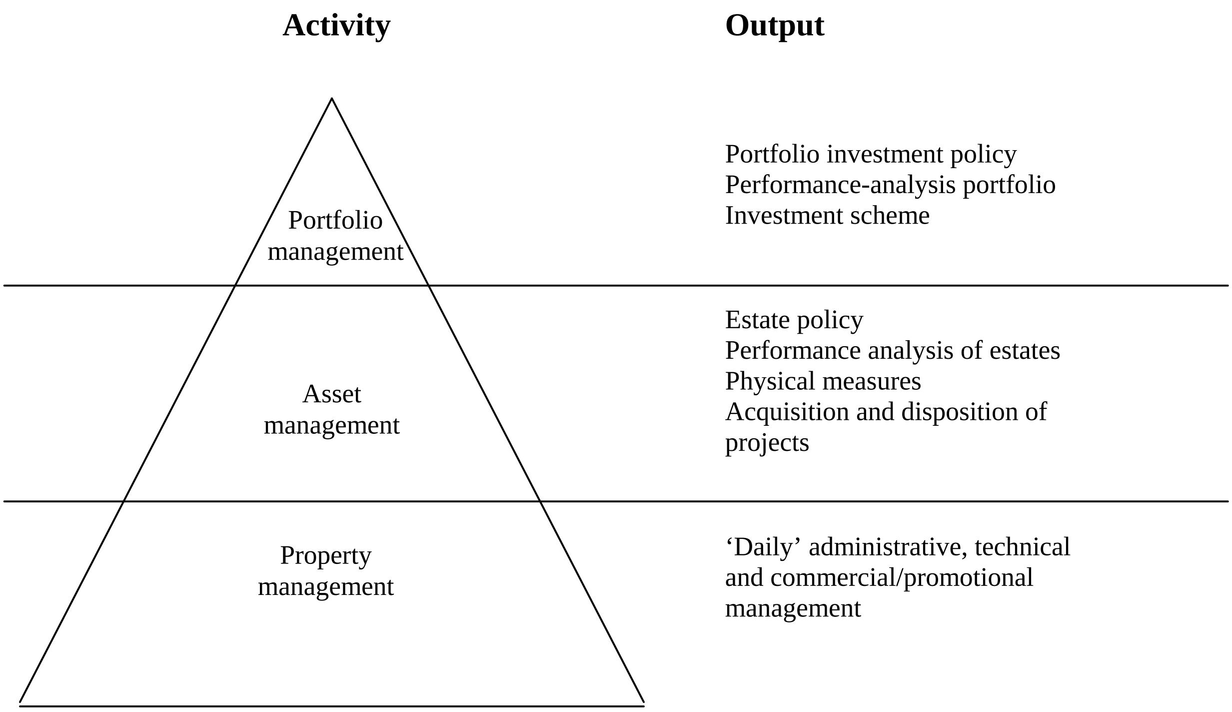
Characteristic	**Housing associations**	**Real estate investors (only IVBN members)**
Number of dwellings	2.3 million	0.2 million
% of total Dutch housing stock	35%	3%
Number of landlords	620	± 20 – 25
Average number of dwellings per landlord	3,800	9,500

Sources: CFV (2002), Ministry of VROM (2002), own calculations

Portfolio, asset and property management

A common distinction in real estate management is made between portfolio management, asset management and property management. Because these terms are used in different ways, it is useful to explain them for the purpose of this paper. Figure 1 contains a summary of the activities performed and output produced at each of these levels according to Van Driel (1998).

Figure 1 *Levels of real estate management (based on Van Driel, 1998)*



Portfolio management concentrates on the allocation of investments among several asset options. Options can be, for instance, shares, bonds or real estate. Within the real estate sector, the main (sub)options are housing, offices and retail. Within housing, dwelling type or regions can be distinguished. Formulating goals about the desired housing portfolio mix is also an important activity in portfolio management. *Asset management* concerns the assessment of individual projects (estates). On the basis of these assessments, it is decided what type of investment will be made in each of these projects (e.g. refurbishment, sale, small improvement, consolidation), and which allocation (target groups) and pricing (rent) policy has to be applied. *Property management*, finally, is concerned with ‘daily’ administrative, technical and commercial management as well as maintenance activities. This paper focusses on asset management, and on portfolio management decisions that have a considerable impact on asset management.

The position of real estate within the total portfolio differs among the interviewed investors. Four real estate investors that we interviewed are specifically specialised in real estate, and two of them in dwellings alone. The other six investors have a wider portfolio.

Strategic aspects of asset management

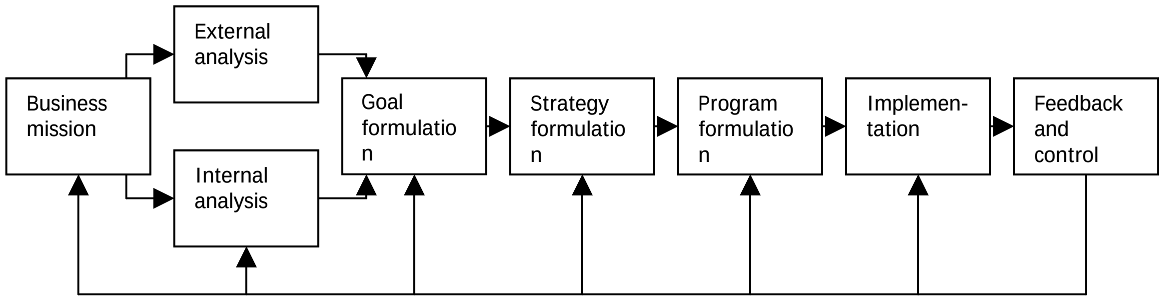
The definition of the ‘strategic’ aspects of asset management can be related to the level in the organisation at which the management activities are performed and to the approach that is followed in drawing up stock policy. In their description of housing management, Priemus et al. (1999) distinguish day-to-day (operational) management and strategic housing management. The latter concerns medium and long-term management policies, usually formulated at a strategic (top-management) level in the organisation.

In business theory on strategic management, other characteristics of a ‘strategic’ approach can be found (see e.g. Ansoff, 1984; Aaker, 1984; Kotler, 1997). Ansoff (ibid., p. xvi) defines strategic management as “a systematic approach for managing strategic change”. So Ansoff emphasises systematic action and change in his definition. We also find the ‘systematic’ as well as the ‘dynamic’ aspect in his definition of strategic planning: “a systematic procedure for management which anticipates the challenge and prepares its responses in advance, based on examination of novel alternatives” (ibid., p. xv). This suggests a dynamic environment, in which the future is *not* necessarily expected to be predictable through extrapolation. As a consequence, in a strategic approach, landlords consider their housing stock not only as a static fact, but also as a dynamic asset. Furthermore, environmental analysis will play an important part in the decision-making process. In all theoretic descriptions of strategic planning, the strategy is based strongly on market or competitive analysis and reacts to opportunities and threats in the business areas in which a company is (potentially) active.

Another important characteristic of strategic planning is that it concerns a firm’s portfolio as a whole. Depending on the level of the strategic planning, strategies are formulated for business areas or product-market combinations. In multiple businesses, strategic planning can be performed at a corporate level, to formulate strategies for the different business areas in which the firm can compete. In focused enterprises or individual business units within a firm, strategies are formulated for the product-markets within the business (see also Aaker, 1984, pp. 4-6). Hence, in a strategic approach landlords do not focus solely on separate estates, but on the composition of the housing stock as a whole. Strategies will be formulated for all product-markets within the housing stock.

Strategic planning results in strategy formulation. On the basis of a business mission and internal and external analysis, organisations formulate goals, which in turn are translated into strategies (see Figure 2, from Kotler, 1997). Thus, in a strategic approach landlords formulate both goals and strategy. They develop a strategic view, in which guidelines are formulated for the development and the future mix of the housing stock.

Figure 2 *The business strategic planning process (according to Kotler, 1997)*

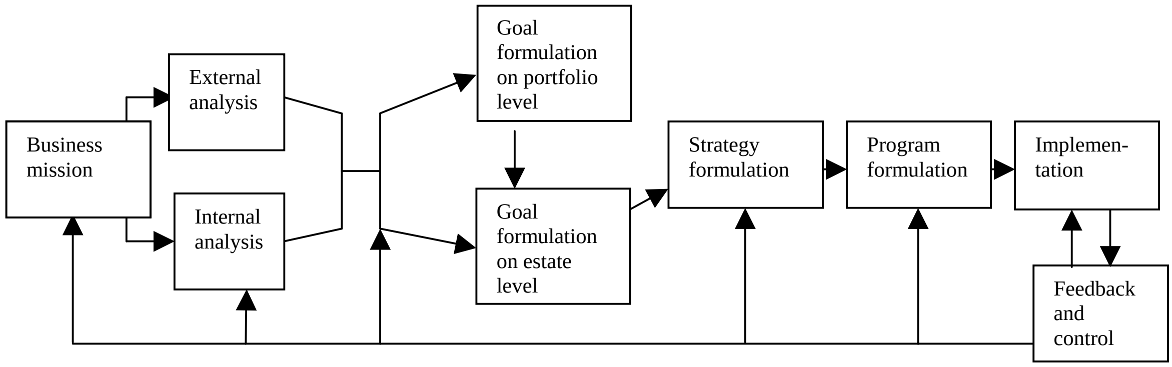


Employing the elements just mentioned, Van den Broeke (1998, pp. 43-44) uses the terms ‘strategic’, ‘market oriented’ and ‘comprehensive’ to typify strategic asset management. Below, we will describe how these characteristics can be applied to asset management of landlords.

Strategic

Van den Broeke (1998) uses the word ‘strategic’ in two ways. First, it refers to a specification of objectives (goals) and a strategy to achieve these objectives. Second, it refers to a level of decision-making within an organisation, namely the (top) management level. Applying these elements to landlords, we expect that landlords specify the desired portfolio (or the desired development of their portfolio) in quantitative and qualitative respect. Statements about the desired composition of the stock are essential in this, as well as guidelines for the application of these statements on the estate level. This level is especially important, because in practice it is the central level in asset management decisions. As we indicated earlier in this paper, we concentrate on the formulation of goals on portfolio level and the ‘translation’ of them to the estate level. We can simply add this distinction to Kotler’s model of strategic planning (see Figure 3).

Figure 3 *Extended version of Kotler’s model on the business strategic planning process*



Market oriented

In strategic asset management, decisions and measures are (explicitly) attuned to market demand and market analysis. Market orientation is central in this approach. In this paper, we discuss whether landlords perform housing market analyses for their residential portfolio in support of their asset management. We also deal with the role of market expectations in these analyses.

Based on the theory of strategic business planning (e.g. Ansoff, 1984), it has been suggested that landlords can use a portfolio analysis of the market position in support of management decisions (e.g. Van Vliet, 1993; Van den Broeke, 1998). In such an analysis, estates are assessed on the basis of their current market position (e.g. on the basis of vacancy and turnover rates) and their future market prospects (e.g. on the basis of housing market research). The outcome of this analysis may be translated directly into suggestions for basic strategies to follow (e.g. ‘grow’ or ‘cherish’ when market position and prospects are good and ‘divest’ when market position and prospects are bad). In this way, portfolio analysis may contribute to a systematic approach to formulate strategies for the housing stock (cf. Van der Flier and Gruis, 2002). We researched if the real estate investors used portfolio analyses in their assset management.

Comprehensive

The term ‘comprehensive’ refers to the focus on the total portfolio: the focus is not only on problem estates, as was usual in the past, but on all estates and their contribution to the total stock. The term also refers to the combination of different aspects of asset management, for example: technical, social and financial aspects, long-term and short-term objectives, top down and bottom up information. We anticipate that landlords practising strategic stock management periodically evaluate all estates on these bases. In this paper, we discuss if these evaluations take place and which aspects are involved.

Extra aspect: systematic

Following Ansoff (1984) we argue that strategic management implies systematic action, in a sense that policy options are chosen in a rationalised, transparent way. Thus, we want to add 'systematic' as a fourth characteristic of strategic asset management. We note that this aspect affects the other characteristics. As for the formulation of goals and guidelines, in a systematic approach we expect a clear translation of these goals and guidelines to criteria for the assessment and appraisal of individual estates. As for the comprehensive aspect, a systematic approach implies that the relative importance of each aspect is weighed in a transparent way, especially in case of conflicting signals and competing interests (e.g. bad technical condition and good lettability; good financial performance, but does not fit in the total portfolio).

Research method and representativity

Our research has been carried out through open interviews (on the basis of a a checklist) with ten real estate investors and a literature study. For interviews has been chosen because of the qualitative and explorative nature of the research questions.

The interviewed real estate investors have been selected from a working group on housing of the IVBN (*Vereniging van Institutionele Beleggers in*

Vastgoed Nederland – Netherlands Association of Institutional Real Estate Investors), the Dutch umbrella organisation of institutional real estate investors. In 1997, the IVBN members owned about 183,000 dwellings in total (Conijn, 1997). Most Dutch real estate investors (and all the larger ones) are members of the IVBN. Owning over 130,000 dwellings, the interviewed organisations manage the majority of all dwellings in the institutional real estate sector, which is estimated to be in the order of 200,000 to 250,000. In addition, ten of the eleven approached organisations agreed to participate in the research. As a consequence, the results of this research can be regarded as representative.

Each organisation has been interviewed at least once. Interviews have been held with officers or staff employees responsible for the asset management of the housing portfolio.

Empirical results

In the description of the results of the research, we use three characteristics of strategic asset management that are mentioned in an earlier section, namely ‘strategic’, ‘market oriented’ and ‘comprehensive’. We do not separately discuss the characteristic ‘systematic’, for this aspect runs through the other three characteristics.

Goals and strategies on portfolio level

Not surprisingly, the goals that real estate investors formulate for their housing portfolios are related to (yearly) returns. Several investors formulate a desired profit (mostly in percentages, in one case in an amount of money) or a desired rate between income and costs. If the actual performance does not achieve this level, changes in the portfolio must follow. Non-financial guidelines and preferences, concerning regions or dwelling types, are frequently used as well, but mainly for financial reasons.

In our research, we found only two investors producing model portfolios that indicate the desired mix of the stock (according to region and type). One of these investors distinguishes 'green', 'yellow' and 'red' areas in order to indicate where investments should be intensified or withdrawn. The other investor calculates which types of dwellings are overrepresented or underrepresented in the present portfolio. Both model portfolios are based on data about, for instance, regional economic development, return-risk ratio and/or housing demand. In both cases, this line of working is rather new for the investors concerned, namely less than five years old.

The interviewed real estate investors are rather homogeneous as far as the type of goals at the portfolio level is concerned. The research shows greater differences in the translation of these goals to decisions on the estate level. Some investors, for instance, are strict in their geographical preference: they invest only in certain regions and disinvest in others. The stock decisions of other investors, however, are more driven by bottom-up information about the performance and the financial prospects of the individual estates and may not be in accordance with guidelines on the portfolio level. In general, real estate investors do not apply structured methods and techniques to weigh top-down guidelines and bottom-up information; intuition and subjective experience prevails. Some investors explicitly state that they consider an eventual development of such methods to be unrealistic and unnecessary.

An important factor is the amount of capital to be invested in housing. In four cases, external investors determine the size of the housing portfolio. The other six real estate investors decide over the desired portfolio mix themselves, on the basis of calculations on profit, risk and, eventually, liquidity. Again, the extent to which the outcome of these calculations is imposed on housing stock management differs among the real estate investors.

Market orientation

One of the characteristics of strategic asset management is its considerable attention to market factors and market analysis. For real estate investors market orientation plays an obvious role in their asset management. All interviewed real estate investors draw up periodical reports on present lettability and vacancies.

Contrary to our expectations, we have not found a real estate investor that uses a kind of *marketing* portfolio analysis as part of its stock management. This suggests that such a technique is not used in practice. We had also expected that many real estate investors would use a *financial* portfolio analysis, in which their estates are set against each other on the basis of risk and return. Our research indicates that this is true as far as the *size* of the real estate portfolio or the housing portfolio is concerned. Use of financial portfolio analysis to determine the *mix* of the residential portfolio, however, is limited. This may be partly explained because it uses stochastic measures for risk and return ('mean, variance'), which are often stated to be difficult to apply to real estate, among others because there is no historical data on which to base the expectations (e.g. Xu, 2002). An earlier survey among Dutch real estate investors by De Wit (1994) has shown that the use of stochastic criteria in real estate investment is uncommon. Little seems to have changed, at least as far as housing investment is concerned.

Although landlords have a lot of information about the *present* market situation, insight into *future* market situations is less developed. Forecasts of market situations, if there are any, mostly do not contain information on the appropriate geographical scale, thus leaving a lot of uncertainty about the future market situation of a landlord's portfolio. Moreover, several landlords have indicated that they regard the market as too dynamic to rely on these forecasts, even if these would specifically be made for their property. For this reason, future market prospects are more based on past experiences and subjective knowledge than on systematic calculations. This, in turn, may partly explain the rare application of portfolio analyses.

Comprehensive evaluation of estates

All interviewed real estate investors evaluate their estates on a regular (mostly yearly) basis to decide what asset management measures (like minor improvements, refurbishment, and sale) should be carried out. In general, these evaluations are carried out in internal sessions, in which all relevant persons take part.

The outcome of the evaluation in terms of stock policy depends, of course, on the criteria that landlords use to evaluate their estates, and also on the way in which they 'weigh' the relative importance of these criteria. We expected connections between these criteria on the one hand and the choice of policy options on the other.

Most real estate investors use minimum return percentages to evaluate their estates. In some cases, the minimum return level varies with the region or the dwelling type: lower return percentages are accepted if estates are in preferred regions or are of a preferred type. In principle, estates that do not meet the minimum percentage are singled out for sale. However, this does not always mean that a sale will be effected. Reinvestment possibilities, tenants' willingness and ability to buy, and agreements with local governments or other parties play a role as well. In particular the lack of reinvestment possibilities can be a hindrance to real estate investors in selling their properties.

Because one criterion, namely return, is dominant, weighing of heterogeneous interests does not play an important role in asset management decisions of real estate investors and is not considered a problem. Thus, it is not surprising that we have not found rationalised techniques, other than financial calculations to weigh competing signals and interests. Some interviewed landlords have even stated that they consider a systematic weighing of relevant aspects unnecessary or even unrealistic. Because of this, we expect little effort to make the valuation of different, dissimilar interests more systematic in the next future.

Conclusions

Although the financial and market considerations of the real estate investors are not surprising, the results of our research can be considered somewhat remarkable, because some elements of strategic asset management prove to be more uncommon among real estate investors than we had expected from the commercial nature of these elements. Examples of this are the rather general goals on the portfolio level, the lack of systematic translation of these goals to the estate level, the absence of market prospects and the limited use of techniques to structure the decision-making process.

Apparently, the amount of money to be invested in housing plays a more important role than guidelines about the mix within the residential portfolio. The reason for this is that guidelines about the *size* of the residential portfolio are rather strictly applied, whereas guidelines about the *mix* of the residential portfolio are mostly too general to have a direct impact on the estate level. In addition, despite the periodic evaluations of all estates, landlords do not have a systematic approach to weigh the relative importance of the different aspects. Consequently, this part of the process remains a 'black box'. Referring to the extended version of Kotler's model (Figure 3), we can conclude that there is a translation from goals on a portfolio level via goals on estate level into formulation of (asset management) strategies, but these translations are rather weak and not systematic.

The absence of market prospects can be seen as a major restriction to strategic asset management, in which anticipating market developments is one of the main objectives. Even if the housing market is indeed so dynamic that adequate forecasts are difficult to make, the long-life span and inflexibility of real estate requires decisions about its future to be based on long-term expectations.

It may well be, that the rationalisation of housing has mainly taken place in the *portfolio management* of real estate investors (in which investments are allocated to basic categories, such as shares, bonds and real estate), whereas the professionalisation of *asset management* has apparently just begun. One of the possible reasons is that real estate management is often stated to be concerned with intuition and ‘soft’ factors, which are not easily combined with a rational, systematic decision-making process. Another possible reason is that most real estate investors, especially pension funds, strive for long-term, stable investments. For this reason, it is not their policy to react to market fluctuations as quickly as short-term investors do.

Opportunities for further development

From a researcher’s point of view, our conclusions may be easily translated into recommendations for practice. If we are right in our assumption that landlords need a strategic approach to their asset management, we can recommend that they:

- develop and adopt models for a systematic assessment of their properties and deliberation about the strategies to follow;
- develop goals at a portfolio level and translate these into clear guidelines for the management of their estates (at least as the basis for the top-down/bottom-up discussion between portfolio and estate managers); and
- specify long-term market prospects for their estates in support of management decisions.

From a practitioner's point of view, however, these recommendations might well be criticised for being purely theoretical, inflexible, 'mechanical', and thus inappropriate to meet the various heterogeneous interests and demands that housing managers have to face in reality. To be clear, we do *not* suggest a fully rationalised way of decision-making, in which all 'subjective' elements are removed. Instead, we suggest a more transparent decision-making process, which will contribute to improved decision-making and to a more effective communication with the parties involved. In particular, we suggest a broader use of model portfolios, which indicate the desired mix of dwellings. Calculations and estimations are frequently used to determine the asset mix of dwellings, offices, shops and other investment categories, but are little used in relation to the asset mix within the residential portfolio. In addition, we suggest a strategy that includes both a time path to achieve the desired residential mix and some moments to check whether the market conditions underlying the calculations and estimations are still valid. This line of working is already practised by some of the interviewed real estate investors, but deserves broader application.

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