Real Property Management

Enhancing Value through Ongoing Management

Reference: Chapter 22: Ling and Archer, Real Estate Principles

Why is Management so Important?

- Making good acquisition decisions is important because they cannot be undone easily or costlessly.
- But what about after property is acquired?

Compare to Public Stock and Bond Markets

- Unlike many publicly traded stock and bond investments, the going-in and going-out transaction costs of commercial RE investments are high.
- Thus, IRRs are usually maximized by holding assets for longer periods.

Compare to Public Stock and Bond Markets

- Also, majority of return comes from periodic net rental income, not from price appreciation.
- Thus......
  - commercial RE returns are determined in no small part by how well ongoing asset management function is performed.

Two Categories of Management Decisions

- Those that deal with day-to-day operations
  - i.e. property management
- Those that deal with the physical, financial, or ownership structure
  - i.e. asset management
Functions of a Property Manager

- Marketing the property
  - Leases are perishable assets
  - Who should lease the property
    - Apartment properties?
    - Office buildings and shopping centers?
      - Independent broker
      - In-house leasing agent – specializes in leasing, paid salary (plus bonus?)
      - Property manager (common for apartments)

- Independent brokers are usually paid on a commission basis
  - Commissions equal a % of the face amount of the lease
  - Example: You offer a broker a 3% commission. The broker just brought you a client whose lease will be 5 years at $8500 per month. What is the commission due to the broker?
  - Solution: $0.03 * 5 * 12 * $8500 = $15,300
  - This amount must be amortized over the 5 year life of the lease

- Selecting tenants
  - Importance of “willingness and ability to pay”
  - Credit tenants (has investment grade rated debt)
  - Vast majority of potential tenants are not credit tenants
  - Tenant mix – try to create synergy
- Signing leases (a contract)
  - Leases ultimately drive NOI
- Collecting rent
  - Expenses are paid out of rental income

- Repairing and maintaining property
  - Objective?
    - Maximization of market value
    - Comprehensive maintenance program
    - Importance of being proactive
    - Aids tenant relations
    - Maintenance as an investment decision
      - PV of benefits versus cost
      - Qualitative vs. quantitative

- Communicating with owners
- Maintaining tenant relations
- Complying with landlord-tenant laws
  - Residential vs. commercial

All States Have Landlord/Tenant Laws
Designed to Protect Residential Tenants

Establishes a more equitable relationship between landlords and tenants
Landlord and Tenant Relations

- Landlord’s obligation to make repairs
- Tenant’s obligation to preserve the premises
- Landlord’s right to inspect
- Landlord’s right of entry

Emergency Access

Notice is not required for emergencies

- Smoke/fire
- Water leak
- Security system
- Storm damage

Property Management Agreement (IREM)

Contents of a Management Agreement

- Parties to the agreement
- Description of the property
- Term of the agreement
- Responsibilities of the manager
  1. Financial management
  2. Reports to ownership
  3. General property management
- Obligations and responsibilities of the owner
  4. Insurance
  5. Operating and reserve fund
  6. Liability
  7. Legal and regulatory compliance
- Compensation for management services
- Provision for termination

Agency Relationship

- Management contract creates an agency relationship between owner (principal) and manager (agent)
- Empowers manager/agent to serve as owner’s fiduciary—words and actions of manager are binding on owner.
- Agent has a legal obligation to exercise care in managing both money and property for owner

Property Management Fees

- Typical property management fee?
  3-6% of Effective Gross Income

- What about incentive compatibility?
  Potential for too much to be spent on marketing and maintenance

- What about basing management fee on net rental income?
Who Hires Property Managers?

According to the Institute of Real Estate Management (IREM), typical employers of property managers include the following:

- Development companies, where staff manage company-owned properties and may take care of tasks from marketing to renovating properties.
- Full-service real estate companies, where property management may be one of several functions handled by the firm.
- Property management firms, which specialize in fee-based management services.
- REITs, which have property management subsidiaries or employ property management firms.
- Commercial banks, who must manage properties obtained in foreclosure.
- Corporations, which often employ in-house staff of outside managers to oversee properties owned for conducting business.
- Government agencies, which employ managers for government housing programs as well as maintenance of the vast stock of government-owned real estate.
- Insurance companies, which often own real estate as part of their investment programs.
- Other property owners and users, including colleges and universities, the military, and non-profit organizations.

Professional Associations and Designations

- IREM
  - Certified property manager (CPM)
  - Accredited resident manager (ARM)—for those specializing in apartment buildings
  - Accredited management organization (AMO)—awarded to management companies
- BOMA
  - Programs aimed primarily at owners and managers of office buildings
  - Real property administrator (RPA)
- IFMA
  - Certified Facility Manager (CFM)

The Development of a Profession

- Asset management is a relatively new profession
- Prior to 1970s, institutional investors did not actively invest in commercial real estate
- Vast majority of commercial RE was held by wealthy families and private partnerships (LPs)
- LPs managed by “managing equity investor”
Asset Management Functions

- **Before property is acquired, asset mgr:**
  - Finds specific assets in which owner/client can invest
  - Researches/arranges the financing
  - Negotiates acquisition price
  - Oversees due diligence and closing process

  These activities are required because investors end up with controlling interests in “whole” assets

- **Compare to managers of stock portfolios!!!**

 Asset Management Functions

- **After property is acquired, asset manager must:**
  - Monitor and control operating performance
  - Site visits, CAPX budgets, property tax assessments
  - Report value-enhancing opportunities for rehabilitation, historic preservation, modernization, and conversion
  - Suggest strategies for lowering owner’s cost of capital
  - Be aware of opportunities to restructure equity ownership
  - Continually reassess buy vs. hold decision

Performance Evaluation and Compensation

- During 1970s and 1980s, investment/asset managers’ compensation based on % of assets under management (AUM)
  - 0.50 to 1.50%

  Policy produces a clear agency problem
  - Managers have an incentive to acquire and hold assets for principal
  - Going-in IRRs may not be paramount

Recent Trends?

- Industry has moved rapidly to performance-based compensation for asset managers
  - Fee tied directly to portfolio performance (i.e. rate of return on portfolio)
  - Owner and manager must agree on the performance benchmark
    - Actual performance of agent typically evaluated over the period of the management contract (typically 3-5 years)

Managing Corporate RE Assets

- Corporations beginning to pay more attention
  - In-house management personal
  - Asset management consultants

Managing Corporate RE Assets

- **Issues:**
  - Site analysis
  - Buy vs. lease decisions
  - Acquisitions and dispositions
  - Portfolio refinancing
  - Facility management
  - Property tax appeals
  - Sale and leaseback arrangements — growing area as offers control without ownership