

## 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?

### Why is Management so Important?

- ▶ Ownership of RE puts investors in business of providing rental services—which is extremely management intensive.
- ▶ Owners or their agents must repeatedly make management decisions that affect value of the property and investors' return on equity.

### 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)

Functions of a Property Manager

- ▶ 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

Functions of a Property Manager

- ▶ **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

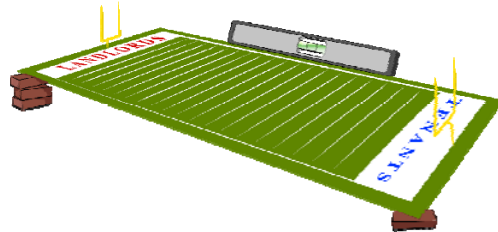
Functions of a Property Manager

- ▶ **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

Functions of a Property Manager

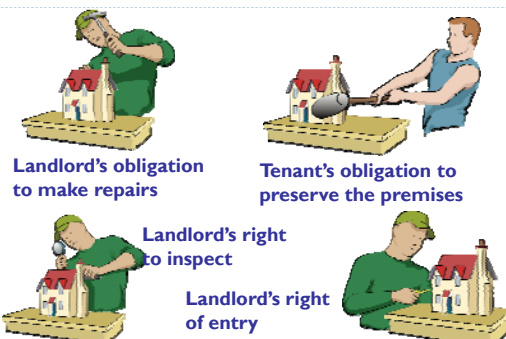
- ▶ **Communicating with owners**
- ▶ **Maintaining tenant relations**
- ▶ **Complying with landlord-tenant laws**
  - ▶ Residential vs. commercial

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



Establishes a more equitable relationship between landlords and tenants

### Landlord and Tenant Relations



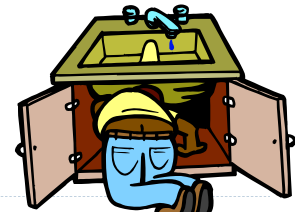
- Landlord's obligation to make repairs
- Tenant's obligation to preserve the premises
- Landlord's right to inspect
- Landlord's right of entry

### Landlord's Access to Unit (cont'd)

- Landlords may enter a premises to:
  - Make repairs
  - Inspect
  - Show the unit

**Reasonable notice:**


- 12-hour lead time
- 7:30am– 8:00pm



### 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
  - Financial management
  - Reports to ownership
  - General property management
- Obligations and responsibilities of the owner
  - Insurance
  - Operating and reserve fund
  - Liability
  - 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.

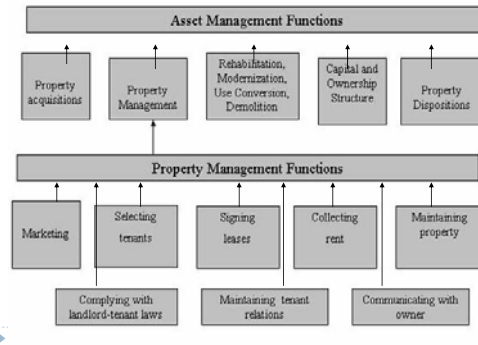
### Professional Associations and Designations

- ▶ **A number of professional and trade organizations exist. The big three are:**
  - ▶ Institute of Real Estate Management (IREM)
  - ▶ Building Owners and Managers Association International (BOMA)
  - ▶ International Facility Management Association (IFMA)
- ▶ **Provide professional education & work to enhance status of professional property managers.**
  - ▶ promote conduct and performance standards
  - ▶ offer professional designations

### 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)

### Property Management: Just One Aspect of Asset Management



### 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”

### The Development of a Profession

- ▶ **In the 1970s**, institutional investors began investing in commercial RE
  - ▶ Perceived value as a diversifier
- ▶ **These new investment funds** transformed commercial RE markets beyond recognition
- ▶ **New breed of third-party asset managers (investment advisors)** was required to “hold the hands” of institutional investors
  - ▶ i.e., take on, in a fiduciary capacity, role of 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
  - ▶ Oversee 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