CenterSquare Investment Management

Disciplined strategy decisions in value-add investing

How CenterSquare's value-add fund series continues to deliver strong performance

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with CenterSquare Investment Management's **Jeffrey Reder,** managing director, private equity real estate, about the firm's value-add fund series and investment strategy. Following is an excerpt of that conversation.

Can you provide some background history on your value-add fund series? How long have you had this strategy? And what is the main focus, in terms of sectors and geography?

CenterSquare has been in the value-add fund business for more than 20 years, having closed five prior funds in the series. Our strategy is focused on two primary sectors: rental housing and industrial. Within those sectors, we concentrate on niche alternative strategies. For example, within industrial, we're very focused on a property type we've identified as "service industrial," which falls into the small-bay industrial category.

We zero in on properties with suites that are 10,000 square feet or smaller, with our average suite size at about 5,000 square feet. These facilities primarily have roll-up doors and truck courts that typically cater to pick-up trucks and box vans rather than tractor-trailers. The focus here is more about providing services to the surrounding community than distributing goods. We like it because it's infill industrial with a well-diversified rent roll in terms of number of tenants and industry exposures. Given the infill locations and high number of demised suites, we're not competing with new supply, and there is a deep array of demand. These strategically located properties are mission-critical spaces where tenants have often invested meaningful amounts of their own capital into the leased spaces, their customer base is in a nearby radius and the business owners live proximate to the property. We compare that with bulk distribution, for example, which tends to be more commodity product, or where new buildings get built with the most modern features, like higher clear heights, where tenants might move to something more functional. We also invest in traditional last-mile industrial and cold storage.

In rental housing, we primarily focus on the build-to-rent space, or what we call purpose-built rental communities. Given the housing affordability crisis across the United States, our goal is to replicate the benefits of traditional home ownership through these communities. We target the three- to four-bedroom product, with two-car garages and yards. We can execute across multiple investment strategies – buying homes from home builders and taking lease-up risk, providing structured equity to complete development and/or lease up or acquire existing communities for income and growth opportunities. The recent dislocation combined with the positive outlook from lack of supply and continued demand creates a compelling opportunity to provide preferred equity to developers who need capital to now proceed with delayed or re-underwritten projects. We also invest in manufactured housing development as a strategy to provide affordable home alternatives.

How did Fund IV build on what you had learned in the previous three funds? What was unique about this fund?

Our execution in Fund IV leveraged many insights from our prior experience. We had learned about the value of sales discipline. Our strategy was to identify high-quality assets in good locations, with physical issues that could be fixed by capital infusion or rent rolls that could be improved to grow NOI and create value. Based on past experience, we learned that what was best for our investors was to harvest that value and return capital shortly upon completion of the business plan because the environment can change. We saw that with assets that didn't get sold before the GFC or the recent rapid reset of interest rates, for example.

We recognize how quickly dynamics can shift in the market, and that informed how we made strategic decisions over the life of Fund IV. In multifamily, for example, we believed the lack of supply of affordable for-sale housing was going to benefit multifamily investment returns through high demand for suburban multifamily. We were active investors in Fund IV, but in the fourth quarter of 2019, we stopped investing in multifamily – not because we didn't believe in the demand side of the equation, and candidly, not because we saw at that point how massive the supply pipeline would become. Rather, it was interest rates and valuations. Interest rates and cap rates were low. People were touting, "This is the new paradigm." We thought, "We've been doing this for 35 years. This is an anomaly. At some point, data and history dictate that things will revert to the mean. Interest rates will rise; cap rates will rise."

We did not want to be stuck paying cap rates below 4 percent, trying to execute these plans. We stopped investing. Then in 2020, the pandemic hit, and we kept our properties full. In 2021, rents took off because we had the right product. We knew we wanted to be in suburban locations with good schools where people wanted to live and have more space.

A key point emerged in 2022 through our regular CenterSquare full platform strategic conversations, as we thought about starting the renovation programs we had originally underwritten to further boost NOI. One of the competitive advantages of our platform on the private side is having these conversations with the REIT team. We saw in 2022, multifamily REIT cap rates were starting to expand. So, I told my team, "The moment we thought was going to happen when we stopped investing back in 2019 is happening. Maybe we don't do the renovations. Let's re-underwrite all of our multifamily investments in Fund IV and model executing the renovation plan, but include cap rate expansion sensitivities, and see what that looks like." We concluded that the value we could create through increased NOI could easily be wiped out by cap rate expansion. A big driver of Fund IV's performance was the directive early in 2022 to sell all of our multifamily by the end of the year. We successfully did that, which meant we sold all of our multifamily at cap rates below 4 percent, to buyers who didn't have that same informational advantage, including to some large, well-respected firms.

We locked in those returns, and then the market shifted, and those 4 percent cap rates became higher than 5 percent pretty quickly. We executed on a huge advantage of, not only having the information, but being nimble enough as a middle-market-sized fund to turn it into action, completely shift and pull forward on our portfolio. That benefited our investors.

What about the industrial side?

The same process transpired with industrial. The popular play was infill, with huge mark-to-markets embedded. The idea was, buy at low cap rates but get the mark-to-market and exit at a still-low cap rate. We thought that lift could get wiped out by exit-cap expansion. So, we bought vacant, excess corporate real estate instead of buying income-producing assets. We sought good-quality product that we could actively fix and then lease up to a higher yield on cost. We did not have to underwrite rapid rent growth. We could expand our exit caps to be more in line with historical averages. Then, again, we practiced sales discipline — as soon as we leased those up, we planned to turn around and sell them, having completed our business plan. These assets would have been attractive to hold for cash flow, but this is a value-add strategy focused on total return and distributing capital back to our investors.

Can you talk more about the impact the macroeconomic environment had on the fund? Where did you have to pivot or lean in as the real estate landscape shifted rapidly?

Interest rates did get very low, and pricing was driving real estate above replacement cost. At the end of the day, we're real estate investors. Our job is to get the real estate right, its location and the basis. These are elements you can control and have clear visibility on. Interest rates are going to change, cap rates are going to change and growth will change. What that focus on the real estate and basis led to — versus financial model projections — in the low-interest-rate environment was our conclusion that assets with in-place income and projected near-term mark-to-market growth were being overvalued at a premium. This was particularly evident in favored sectors such as industrial and multifamily. So, that meant we were buying more vacancy to access favored sectors at a better basis and taking on lease-up execution to achieve higher yields on cost and a rationale spread to reasonably adjusted exit cap rates. In Fund V, for example, we continued that theme — buy good vacant real estate at the right basis, reposition it, get to a superior yield on cost. But then, halfway through Fund V, came the reset, with interest rates increasing rapidly. As we finished investing Fund V, we pivoted, and now we can buy income. Now we're buying service-industrial assets that are well occupied with meaningful mark-to-market rent growth opportunities to achieve higher yields on cost. After avoiding traditional multifamily since the fourth quarter of 2019, our first investment in our latest fund in the series was a foray back into suburban multifamily because the basis made sense again. Being able to tactically adjust to find the best risk-adjusted return opportunities across an ever-shifting investment landscape while maintaining a focus on the favorable sectors that you've identified as fundamentally strong is an important strategic advantage.

How is your investment process unique? What aspects of this process contributed to your ability to successfully execute on your strategy in Fund IV?

In investing, we always look at the real estate first. We use property scorecards we've developed over our history to maintain our discipline. They enable us to use objective data to identify specific assets within our target sectors that we will proactively pursue. These scorecards have been refined and adjusted over many years of operating and investing experience to reflect what is most impactful based on the data. We get the bricks and sticks right first.

Our proprietary target market analysis guides which markets we want to be in, drilling even further down into submarkets for property types. We can then say, these are the specific locations and submarkets we want to be in, and these are the specific property profiles we're seeking. As a result, more than 85 percent of our investments across the Value-Add Fund business have been sourced off-market. We know which assets we want, and we have the right relationships to execute. We proactively find these deals off-market rather than being the highest bidder in a widely marketed process.

Another element in our process is the "A–C Analysis." We don't laminate our initial underwriting and business plan and put it on a shelf after we close. Rather, every day we hold an investment, it's like we're buying it again. We constantly evaluate through our proprietary analysis that addresses current market conditions and make decisions about how we see value incorporating future upside and downside risks relative to where we see the market valuing the asset. If the analysis tells us we should be sellers rather than buyers, or vice versa, then that analysis drives our decision.

CONTRIBUTOR

Jeffrey Reder
Managing Director, Private Equity Real Estate
CenterSquare Investment Management

Jeffrey Reder is a managing director in the Private Equity Real Estate Group. He joined CenterSquare in 2006. Reder serves as a portfolio manager for both the Value-Added Fund strategy and a separate account relationship, while overseeing a team focused on sourcing, underwriting, closing, financing and executing business plans for real estate transactions across the industrial and rental housing sectors.

CORPORATE CONTACT

For inquiries: +1 610-834-9500 | contactus@centersquare.come

CORPORATE OVERVIEW

CenterSquare is sharply focused on investing in solutions to capture the opportunities created by secular demand patterns that impact the purpose, place and performance of real estate. CenterSquare has built a time-tested process of value creation, combining best-in-class macro research with advantageous localized expertise and capabilities that drive our informed direct investment approach. With the goal of delivering attractive, risk-adjusted returns to investors, CenterSquare raised its first value-add real estate fund in 2003, has closed five funds to date, totaling more than $1 billion, and has managed $2.5 billion of separate account mandates since 1988. At CenterSquare, we believe exceptional real estate investment opportunities are identified through relentless focus and disciplined research around well-honed thematics.

CenterSquare
REAL ASSET INVESTMENT LEADERSHIP