KEYNOTE INTERVIEW

Economies of scale

Partners Group's Jessica Wichser and Kelly Xu address the challenges associated with scaling up management-intensive value-add residential and logistics portfolios

The logistics and residential sectors are very much in vogue, with investors, such as Partners Group, adopting a thematic approach underpinned by secular trends. The value of individual assets in the logistics and residential sectors is frequently much smaller than in office. This means that the skill set associated with building up a portfolio of small real estate assets and managing it efficiently to add value is in greater demand than ever before.

Jessica Wichser, global co-head of private real estate asset management at Partners Group, and Kelly Xu, the firm's head of asset management for APAC, consider best practice approaches to the challenges associated with growing portfolios of granular value-add assets and managing them to create cross-platform efficiencies.

SPONSOR
PARTNERS GROUP

Q How important is a seed portfolio? What characteristics should it have?

Jessica Wichser: I believe you need a seed portfolio that enables proof of concept and is aligned with your long-term vision for the entire venture. It should be representative of how your scaled up portfolio will look. If the risk profile of the seed portfolio is too high, then you can get sidetracked into an overcomplicated business plan that will take resources away from acquiring additional assets. If the portfolio has characteristics that are too core-like, you might not hit your return targets without higher-risk, accretive acquisitions. You also don't want to buy a seed portfolio that is too pricey and then have to find assets at better prices in the future, because you can never count on the market moving in the direction that you want it to.

Q What's the best way to build flexibility into your acquisitions criteria while avoiding strategy drift?

Kelly Xu: At Partners Group, we have a rigorous due diligence process, which is crucial for managing risk but can add time to the acquisition process. Therefore, to scale up quickly, we can set up a "sandbox" – a narrow set of criteria identifying the asset type, submarket, return and business plan that align with the strategy's core criteria. For assets that fit within the sandbox, we have a

streamlined approvals process that enables us to move faster to secure investments.

JW: It is important to set criteria to prevent strategy drift, but it is also important to revisit your strategy often to ensure it remains relevant when market conditions are changing rapidly. For instance, is your yield on cost metric still appropriate given rising cap rates and 10-year treasuries? Are your rent escalation clauses still appropriate given rising inflation? When we set up a sandbox, we have to re-evaluate it often to ensure that we can continue to achieve the right results.

Q What approaches can be adopted to manage properties within granular portfolios more efficiently?

JW: While it is management-intensive to build a granular portfolio of scale, there are ways to reduce the operational intensity of the underlying properties themselves. You can leverage proptech to reduce labor costs, enable preventive maintenance, drive revenue through dynamic pricing and reduce opex through centralized building system monitoring. There is a lot of technology out there that you can access, and the larger the portfolio, the more viable it is to invest in the upfront cost.

Also, we can create a brand identity for our residential or industrial assets within a particular geography, with a standardized marketing strategy such as one website providing a single point of access for leasing.

This allows for more efficient management of the portfolio while passing on lower costs to tenants and providing more amenities for them. For example, in multifamily properties, tenants may use the website to select add-on services such as cleaning or furniture rental, allowing tenants to access services at a lower cost than they could get individually while also acting as a revenue generator for the manager.

Q What are the key factors when evaluating the competitive landscape before rolling out a strategy?

Jessica Wichser: You need to understand which other investors are in the space and their cost of capital. Being consistently outbid will prevent you from expanding quickly. If the market gets too crowded, it inhibits the first mover advantage that would allow you to realize economies of scale, and therefore be more competitive on pricing. It becomes a self-fulfilling prophecy.

Residential and industrial are in-favor sectors right now, so it helps your competitive position to be able to underwrite more aggressively on certain metrics because you have already scaled in the space, and you can realize cost savings. Having both experience in a space as well as funds available to deploy can also be an advantage when looking to capitalize on the distressed opportunities that we are now beginning to see.

Kelly Xu: The multifamily and logistics sectors have become so competitive that in some cases core capital starts to move up the risk curve and competes with value-add investors. One strategy you may adopt is to find sub-markets that are not already saturated. For example, Partners Group started to build up a logistics portfolio in India in 2019, at a time when many other institutional investors had not yet become comfortable with that market. In Indian logistics, the market fundamentals are strong, but the biggest challenges and risks are associated with acquiring land, getting entitlements and permits, and managing the construction process.

We focused on amalgamating a portfolio of already completed and leased buildings to reduce our risk exposure to those areas. We were able to build up a high-quality logistics portfolio because we had the early-mover advantage. In addition, we were clear with our investment strategy from day one in terms of the risks that we would take and risks that we would not. This has kept our sourcing and asset management activities focused and efficient.

Partners Group started building a logistics portfolio in India in 2019

SOURCE: PARTNERS GROUP/XANDER GROUP

Q How should asset managers balance using in-house asset management expertise and employing specialist local partners?

JW: Managers need to know when to leverage their size to realize efficiencies – for example through standard agreements, centralized reporting and achieving preferential pricing by using the same vendors across the portfolio. But ultimately real estate is a local business, so they also need to be aware of when it is better to engage local partners on the ground that are experts in the market. By diversifying your vendors, you can sometimes assess best practices, get local attention and competitively tender services.

It is sometimes a matter of distinguishing between the strategic aspects of a business plan, where it might be better to look at things from a national or regional perspective, and the operational aspects, where local solutions can be preferable.

Sometimes you need to push partners to scale up alongside you. It is important to align your internal processes with those of your partners so everyone knows what your ambitions are and the scale you are looking to achieve.

KX: Skilling up to handle a management-intensive portfolio is not easy. However, Partners Group has a thematic approach to investing that allows us to build up our internal expertise in management-intensive sectors like multifamily and logistics over time.

Meanwhile, we are also developing a network of experts including leasing agents, architects, general contractors, quantity surveyors, property management companies and tax and legal advisers.

Having long-term relationships with those partners allows you to move faster when scaling up, because you already have the right team and the best practice in place. Furthermore, the legal and governance documents, tax structures and reporting requirements are already established and well understood.

"It is important to set criteria to prevent strategy drift, but it is also important to revisit your strategy often to ensure it remains relevant when market conditions are rapidly changing"

JESSICA WICHSER

"Skilling up to handle a management-intensive portfolio is not easy"

KELLY XU

Q What are the difficulties involved with reporting in an aggregation strategy? How important is reporting and selecting the right key performance indicators?

JW: In an aggregation strategy, reporting is particularly challenging because you inevitably acquire assets at a different pace than the pace you have underwritten. You might end up amassing a larger portfolio more quickly, or the opposite.

Therefore, when you are comparing your underwritten projections for revenue, expenses, NOI and cashflow to the actual performance, you need to normalize for that altered speed of build-up by comparing performance on a per-unit basis or looking at the "same store" portfolio performance, and separately, the new acquisition performance and finally the blended average.

The importance of reporting should not be underestimated. Reporting the right KPIs enables you to turn data into insights that can shape a strategy. Managers should compare KPIs to underwriting and the annual business plan and to wider market performance. Such reporting of metrics like rent growth, occupancy, turnover and delinquencies can tell you a lot about the health of your portfolio, how you are performing compared with your peers, and the health of the sector.

You should also examine KPIs in a historical context and use research for forecasts, even outside of the portfolio's hold period. Historical data can help inform whether a strategy will be resilient to an economic downturn, which is something that a lot of investors will be focused on given the current macroeconomic uncertainty. ■