

ASSET MANAGEMENT: SERVICE QUALITY  
THE INSTITUTIONAL INVESTOR PERSPECTIVE

by

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Submitted to the Department of  
Architecture in Partial Fulfillment of  
the Requirements for the  
Degree of

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at the

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## **ABSTRACT:**

The 1990's are making up for the booming real estate industry experienced in the 1980's. Institutional investors actively invested in predominantly non-residential real estate during the 1980's. At this time, several legislative actions opened the door for institutions to invest in real estate, which eventually led to their unwilling ownership of these investments in the 1990's. With the oversupply of real estate in most markets, several developers have been forced into bankruptcy or into default on their loans.

Suddenly the once passive investors, institutions, found themselves with the responsibility of owning and managing these distressed assets. With the competitive marketplace, institutional investors have realized the importance of service quality. They have placed greater demands on asset and property management due to the sophistication of the market and the distressed state of most of the properties.

To effectively address this ownership role, the institutions must decide whether or maintain management of the assets internally or to outsource the responsibilities to a service provider. The emphasis among institutional owners is to develop the best management strategy that will provide service quality. Nineteen institutional owners were interviewed, including insurance companies, banks, and pension funds, to analyze how they achieve asset management service quality. Through an interview process, it was found that institutional owners retain a certain level of expertise internally and outsource property management and other responsibilities that are not feasible to retain internally.

Thesis Supervisor: Sandra Lambert

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## **ASSET MANAGEMENT: SERVICE QUALITY THE INSTITUTIONAL INVESTOR PERSPECTIVE**

Acknowledgments .....	3
CHAPTER 1: STATEMENT OF PURPOSE .....	4
Introduction .....	4
Methodology.....	5
Industry Trends.....	7
The State of the Real Estate Industry.....	7
Characteristics of Banks and Insurance Companies .....	13
Characteristics of Pension Funds.....	15
Summary.....	17
CHAPTER 2.....	19
Asset and Property Management.....	19
Historical Perspective.....	19
Changes in Asset and Property Management.....	20
Changes in Asset Management.....	21
Changes in Property Management .....	25
Summary.....	26
Institutional Users of Asset and Property .....	27
Management Services .....	27
Asset Management and Service Quality .....	30
Definition of Quality.....	32
Developing a Culture of Quality.....	35
Measuring Quality.....	36
Building a Quality Team .....	39
Role of Outside Providers in Achieving Service.....	40
Quality.....	40
In-House Asset Management.....	41
Out-Sourcing.....	43
CHAPTER 3 - Institutional Owners Respond to the Changing Market.....	46
Respondent Profile.....	47
Insurance Companies .....	49
Organizational Structure.....	49
Current Portfolio Status.....	49
Banking Institutions .....	50
Corporate Pension Funds .....	52
Organizational Strategy .....	52

Current Portfolio Status .....	52
Portfolio Management Strategy .....	52
The Credentials and Responsibilities of Asset Management .....	54
Overview .....	54
The Insurance Company's Perspective .....	55
Credentials .....	55
Responsibilities .....	55
The Bank's Perspective .....	57
Credentials .....	57
Responsibilities .....	58
Corporate Pension Funds Perspective .....	59
Credentials .....	59
Responsibilities .....	60
Summary .....	61
Outsourcing to Third Party Management Companies .....	62
Insurance Companies .....	63
Banks .....	64
Corporate Pension Funds .....	65
The Process of Choosing a Service Provider .....	67
Summary .....	69
Important Responsibilities of Third Party Management .....	71
Introduction .....	71
Insurance Companies .....	71
Responsibilities .....	71
Measure Success .....	72
Banks .....	73
Responsibilities .....	73
Measure Success .....	73
Pension Funds .....	74
Responsibilities .....	74
Measure Success .....	75
Summary .....	75
Service Quality .....	78
Chapter 4 -Institutional management in Practice .....	82
Outsourcing vs. In-house Management .....	83
Developing a Culture of Quality .....	85
Shifting Roles and Responsibilities of Asset and Property Management .....	85
Institutional Owners .....	86
Credentials for Internal Asset Management .....	88

Lines of Communication ..... 89  
Measuring Quality ..... 90  
    Internal Asset Management ..... 90  
    Outside Service Providers..... 91  
    Measuring the Performance of the Service Provider ..... 92  
Building a team..... 93  
    Selection Criteria for Third Party Management ..... 93  
    Integration of Asset and Property Management Roles..... 94  
Conclusions ..... 94  
Bibliography ..... 98

## CHAPTER 1: STATEMENT OF PURPOSE

### INTRODUCTION

The Real Estate industry has experienced significant changes over the past five years. The mid 80's featured a major boom in real estate development and investment: according to the F.W. Dodge division of McGraw Hill, "nearly 2.8 billion square feet of office space was built during the 80's - about 17 times the total inventory of metropolitan Chicago at the end of the decade."<sup>1</sup> Institutional investors now own a total \$242 billion<sup>2</sup> of non-residential real estate across the country. Banks, insurance companies, and pension funds were major players during this prosperous stage in the real estate industry. It is estimated that anywhere from 60-100% of institutional owners' real estate equity portfolio is non-residential, including, office, retail, warehouse, hotel/motel, and industrial. These were the hardest hit markets during the recession. With the recent recession and oversupply in the industry, many developers have experienced bankruptcy. This has triggered greater attention to existing stock and has posed significant challenges to the institutional investment community. First, many pension fund, bank, and insurance investors have now found themselves owners of their real estate investments due to foreclosed projects. As a consequence, their equity portfolios are now contaminated with overvalued properties that have reverted back to the investors. With this new ownership role, these institutions need to ensure quality management to maintain and increase the value of their investments. Second, institutional investors have been forced to acquire new capabilities to

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<sup>1</sup>Arthur Andersen Real Estate Services Group, Managing the Future: Real Estate in the 1990's, IREM, 1991

<sup>2</sup>Ibid., p. 32.

successfully manage foreclosed properties, in the context of intense competition for tenants and management contracts within overbuilt markets.

The increased competition for tenants has caused a growth in demand for "quality" asset and property management. As equity owners, investors need to be more involved in the overall management of their assets. This in turn has required that they achieve a core in-house expertise to manage their real estate portfolio strategies that they find the right balance between in-house and third party management. The trend of the 90's, among the asset and property management companies, is an orientation to quality service, and meeting the urgent needs of the institutional owner to regain value in their properties.

## **METHODOLOGY**

This thesis analyzes the needs and trends in the market as it pertains to the management of real estate assets owned by institutional investors. The institutions are aware of their financial obligations, but do not have the historical working knowledge of their real estate investments. This requires them to look to service providers for some if not all their real estate needs. This thesis attempts to shed light on several important questions that institutional investors currently face. What are the needs of the institutional owners? Do they retain an expert in-house or contract from outside professionals? If they choose to out-source services, how do they determine what management company to utilize? What do the institutional owners consider the major components of service quality?

First, this thesis describes contemporary asset management strategies



used by institutional owners which have been documented in recent journal articles. Second, a questionnaire was formatted to look specifically at asset management in today's institutional owners. Executives from nineteen firms were interviewed for this research, including ten insurance companies, three pension funds, and six banks. They all have found the need to organize a real estate department in order to reduce the gap that has been created between property and owner due to these foreclosed properties. Each has maintained a certain level of expertise in-house to better focus on asset performance rather than the various operational aspects of the property. Each firm has similar needs for outside service providers. The diversity of the institutions interviewed, however, provides the opportunity to compare and contrast how different institutional investors make asset management decisions about the service providers who meet their needs. My conclusions were formed via personal interviews with executives in the real estate department of nineteen organizations. In some cases additional interviews were made with other individuals who actually conduct the various decision processes in relation to third party management. Relationships between owner and provider were analyzed. RFP's were collected from various organizations to confirm the findings of the interviews. Finally, other professionals in the industry were contacted for their insight on the topic.

Chapter one of the paper focuses on trends in the real estate industry and the characteristics of contemporary institutional investor/owners. It includes an overview of how the real estate market declined and how the structure of the industry changed.

Chapter two focuses on the importance of asset management to improve the de-valued real estate and assist the unwilling owners of these properties. There are new demands on asset managers to regain value on these real estate portfolios. One important issue presented in the chapter is how service quality is becoming an important component in the success of asset and property management. Components of service quality such as developing a culture of quality, measuring quality, building a quality team, and retaining tenants will be discussed. The final section of this chapter addresses the question of when institutions should outsource asset and property management and when they should build internal capacity.

Chapter three looks at the executives' decision making processes when contracting third party management, the criteria they seek in hiring an outside firm, and the expectations they have for the firm hired.

Chapter four provides analysis of the data gathered within the service quality framework and some general conclusions about the institutional investors needs over the next decade.

## **INDUSTRY TRENDS**

### **The State of the Real Estate Industry**

Real Estate markets are overbuilt and real estate assets have experienced de-valuation across the country. During the 1980's, real estate investment was encouraged by the government through the deregulation of the banking industry.

Combined with trends in interest rates and asset securitization, these three occurrences opened additional channels for investment funds with lower interest rates and easier means of acquiring. Pensions fund investors found their first significant opportunity to enter the real estate markets in 1974 with the passage of the Employment Retirement Income Security Act (ERISA), which placed certain diversification requirements on their funds. It was not until recently that pension funds have expanded their portfolios into the real estate sector: "From 1986 to 1991, pension funds doubled their stake in commercial real estate to \$100 billion."<sup>3</sup> The Economic Tax Recovery Act of 1981 (ERTA) opened the door for investors to utilize real estate as a tax shelter. This tax act hurt other aspects of the economy such as, "increasing fiscal troubles at state and local levels, soaring debt loads and chronic mild inflation,"<sup>4</sup> and was replaced by tax reforms in 1986. This new tax act, in 1986, decreased almost all income-tax incentives to own, build or remodel real estate. The act presented three consequences: "(1) It drove individual investors and small syndicates out of the investment-properties market in favor of essentially tax exempt institutions and pension funds; (2) by reducing tax rates at the margin, it increased the after-tax cost of home ownership to many people; and (3) by eliminating tax shelters as an inducement to equity investors, it hastened the collapse of thrifts, many of which already had been undermined by farm problems earlier in the decade by the Oil Belt debacle of 1985."<sup>5</sup> This resulted in replacement of investor syndicates by institutions that are indifferent to income taxation.

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<sup>3</sup>JPM News, "Pension Funds Uneasy", *Journal of Property Management*, May/June 1992, p. 7.

<sup>4</sup>Arthur Andersen Real Estate Services Group, Managing the Future: Real Estate in the 1990's, IREM, 1991, p 18.

<sup>5</sup>Ibid, p 20.

Large corporations expanded nationally and internationally, opening or acquiring space across the nation and in new countries. This resulted in a greater demand for high rise office space. Technology helped spur the growth of corporations across the country. Personal computers, modems, fax machines and cellular telephones accelerated this office building boom, by allowing the decentralization and expansion of companies. It also expedited the growth of companies and their ability to do business across the country and internationally. Foreign investors also ignited an increase in development by investing in U. S. real estate.

Investing in real estate development in the U. S. in the 1980's was so profitable many projects were built on pure speculation. People were investing in real estate with little concern about the normal corporate approval processes. Investors felt nothing could go wrong, "... whenever investors are swamped with funds and are rewarded for placing them, they will keep on placing them regardless of the prudence of the deals involved. If lending officers swamped with money can't make good deals, they will make bad ones; if they can't make bad ones, they will make terrible ones; if they can't make terrible ones they will make horrible ones-but they will make deals."<sup>6</sup>

The overbuilding of the 1980's has resulted in high vacancy rates, for example, "Across 32 major office markets, the national vacancy rate at midyear stood at 18.9%, up from a low of 4% in 1980 and well above peak vacancy during

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<sup>6</sup>Downs, Anthony, "What Have We Learned From The 1980's Experience?", *Salomon Brothers Real Estate Investment Report*, July, 1992, p2.

the last real estate downturn, which was 15% in 1975."<sup>7</sup> This scenario was experienced in all categories of real estate and was felt nationwide. The incredible space glut and credit crunch will make commercial development in real estate in low demand for the next three to five years: "With an oversupply of office space and hotel rooms large enough to accommodate at least three years of nominal growth in most cities; there is little chance rents will rise fast enough to outpace expense increases and general inflation."<sup>8</sup> This will limit real estate transaction volumes due to de-valued properties, but could also affect leasing efforts if funds are not made available for tenant improvements.

The 90's has also seen an "institutionalization" of real estate ownership, which presents a separation of ownership from management. This has occurred via foreclosures, liquidations and mergers. Properties are reverting back to the institutional owners, who are not in close proximity to their assets. With the increase of these large institutions becoming owners of real estate assets, there are fewer "traditional" real estate "owners" that retained hands-on real estate knowledge and experience through development and direct management of their assets. Some have argued that this economic environment will consolidate the market: "Weak players and superfluous properties will be removed from the market, they say, while others address themselves effectively to meet real needs [of the industry]."<sup>9</sup>

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<sup>7</sup>Wheaton, W.C. and Torto, Raymond G., "The Prospect for Rebound in the Commercial Real Estate Market," *Real Estate Review*, Winter, 1992, p.92.

<sup>8</sup>Arthur Andersen Real Estate Services group, Managing the Future: Real Estate in the 1990's, IREM, 1991, p. 4

<sup>9</sup>Arthur Andersen Real estate Services group, Managing the Future: Real Estate in the 1990's, IREM, 1991

Many institutions have met these needs by forming a real estate department, also referred to as a REO (Real Estate Owned) to oversee a full range of duties for the portfolio from third party management to property disposition. Although some institutions are forming their own real estate departments, the increased presence of institutional owners in the marketplace places greater significance in real estate advising, asset management and property management.

This has resulted in an increase in competition among management companies as well as the displacement of many developers. Development and brokerage companies are finding less of a need for their services and consolidating themselves into management and consulting related firms. People are being laid off as development dries up, sales decline, properties lose value, and many investors retrench their money from the real estate arena. There is a definite transformation in today's real estate industry to attempt to address the increased needs for managing the real estate assets. The focus is now on providing better managed products to the marketplace through decreasing operating costs and improved on-site property management.

With all of the effects of the current economy, real estate professionals have been forced to alter their behavior in the industry. The following is a summary of some of the major changes in today's market.

## **MAJOR CHANGES IN THE REAL ESTATE MARKET**<sup>10</sup>

- "Capital shortages and the space glut mean that few new buildings will be built other than single family residences, though some apartments will be needed to accommodate the swelling elderly populations and the special needs of the disabled, the poor and homeless."
- "Commercial and apartment tenants will take full advantage of their bargaining position, causing real rents to continue their recent decline."
- "Property values, especially investment properties, will shrink or at best lose some of their ebullience."
- "Brokerage deals involving major properties will be few, with downward pressure on commissions and more direct principal to principal transactions, aided where necessary by outside consultants."

According to a study conducted by Morris Newman, editor of California Planning and Development Report, pension fund investors have found that their real estate properties, which are predominantly CBD and suburban office buildings, have dropped 20 to 30 percent in value in the declining market - often below their original price. Along with this, the yields on their real estate investments have not even kept up with inflation. Yields have risen only 2.7% in the past five years, versus average growth of 4% to 5% annually in the 1970's and early 1980's. These statistics are triggering concern among the pension fund investors. Approximately 31% of pension fund sponsors plan to withdraw from real estate.<sup>11</sup> This is less than one third of the total pension fund investors; the balance are remaining active in the market. About 22% of current pension fund investors see the down market as an opportunity to invest in choice properties at

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<sup>10</sup>Ibid.

<sup>11</sup>Newman, Morris, "New Demands from Pension Fund Investors", *Journal of Property Management*, September/October 1992, p.52.

discounted prices.<sup>12</sup> The mood of the investors continues to steer away from investment in development activities. According to William J. Chadwick, president of PSI Institutional Realty in Glendale, CA, "Three to five years ago, there was an active universe of about 250 U.S. pension fund investors today to raise money for development activities there are none. For acquisitions there might be 12."<sup>13</sup> The declining values in the real estate industry have caused pension funds and other institutional investors to rethink their involvement in real estate.

In summary, the 90's will be a time of slow growth all around. U. S. employment is expected to grow at only 2% annually which is the slowest it's been in decades. This slow growth in employment is expected to reflect slow improvement in commercial absorption. High vacancies will remain, keeping rents low. Therefore pressure will continue to be placed on the management arm of the industry.

### **Characteristics of Banks and Insurance Companies**

Institutional investors historically played the role of the passive investor, acting as the money partner in a development. The recent instability in the industry has forced them into a more active role as owner. As stated previously, the current real estate assets held by the institutions are de-valued, therefore the institutional owners must hold onto the assets in anticipation of regaining some of the losses. This increases the illiquidity of real estate, due to the length of time the

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<sup>12</sup>Ibid.

<sup>13</sup>Powers, Marie, "Pension Funds Divided on Wisdom of Investing in Real Estate," *National Real Estate Investor*, September, 1992, p. 38.



assets will have to be held for recovery of value. Most institutions have the ability to wait out the down cycle in the market, but the combination of internal and external changes have forced some institutions to be more desperate about disposing of the distressed properties. For the banks, federal regulations have mandated that the institutions dispose of all properties taken back through foreclosure. Some insurance companies are facing insolvency due to the large amount of assets being "written down" as a consequence of these foreclosures. All institutional investors are currently trying to work through their portfolios to recover as many losses as possible. Institutions have certain characteristics in common in their investment strategies:

<b>CHARACTERISTICS<sup>14</sup></b>
<ul style="list-style-type: none"><li>• Don't like risk - can't expose funds to a high level of risk.</li><li>• Willing to increase financial commitment.</li><li>• Long term view - capital being contributed exceeds outgoing demand - look for future needs of outgoing demand.</li><li>• Need good return within a reasonable period of time and investment must produce better return than alternative investments.</li></ul>

The recent changes in the real estate economy have forced the institutions to become active in the real estate investments, altering their expectations for managing their assets. They are demanding much from their asset and property managers and monitoring all aspects of their investments regularly.

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<sup>14</sup>Ibid.

## **Characteristics of Pension Funds**

In the 1980's, pension funds first entered the real estate market because it was an alternative asset class to their traditional investments in the stock and bond market. "Most of their portfolios were created by opportunistic acquisition strategies, and regional downturns and oversupply in product markets have led to poor returns for many investors."<sup>15</sup> Part of the trouble pension funds ran into with their real estate portfolios was their failure to diversify across product types. In their initial investments their portfolios skewed towards office buildings, as well industrial and retail projects. In a recent study conducted by Marc Louargand of MIT, it is seen now that pension funds will invest more in low and moderate residential projects.<sup>16</sup> One reason for this is the political pressure to fill a gap in the funding for a needed commodity. There currently is a deficiency in the availability of housing in general, but more specifically better quality housing. It will also provide a beneficial way to diversify their current portfolios, since "residential property behaves differently from commercial property under changing economic conditions..."<sup>17</sup> Finally, pension funds also feel certain pressures to invest in low and moderate income housing due to their investor profiles. Most pension funds are products of moderate and upper income people, who have a vested interest in where their money is invested.

In addition to the opportunities in housing mentioned above, several funds plan to exercise a strategy of purchasing additional commercial properties in this down

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<sup>15</sup>Louargand, Marc A., "Pension Fund Investment in Housing", MIT Center for real Estate, Working paper #34, September 1991, p. 2.

<sup>16</sup>Louargand, Marc A., "Pension Fund Investment in Housing", MIT Center for real Estate, Working paper #34, September 1991, p. 2.

<sup>17</sup>Ibid.

market. They are looking for undervalued assets in over built markets that are fundamentally strong with a goal of increasing the value over the long term.

Historically, pension funds looked to real estate as a way to hedge inflation. Real estate is thought to be an inflation hedge due to the theory that rents will go up with inflation, thus increase revenues. This is seen most commonly in residential real estate because of shorter rental terms. Some secondary reasons for real estate investment are due to the superior returns compared with the stock market, lower risk compared to the stock market, and the long duration of the investment.<sup>18</sup> According to a research study performed by Frank Moody, director of the San Francisco office of the Yarmouth Group, (a national real estate advisory firm) institutional investment objectives in real estate can be summarized in the following way:<sup>19</sup>

**Preservation of capital** -The institution has an obligation to preserve the capital that has been allocated to the fund or collected from the fund's participants.

**Capital appreciation** - To provide an acceptable distribution to the fund's participants at retirement, the fund must generate substantial appreciation in it's assets.

**Production of income** - In addition to long-term capital value appreciation, the fund needs an income stream that is consistent with the cash distributions from the pension plan.

**Portfolio diversification** - A fund cannot take the risk of being overweighted in a single asset classification, as evidenced by the stock market crash of in 1987. Quality real estate offers this diversification.

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<sup>18</sup>Pension Real Estate Association 1991 Plan Sponsor Survey, PREA.

<sup>19</sup>Powers, Marie, "Pension Funds Divided on Wisdom of Investing in Real Estate," *National Real Estate Investor*, September, 1992, p. 38.

**Inflation hedge** - Many investments do not fare well in periods of heavy inflation, whereas real estate investment has historically fared well in times of inflation; this is especially true of retail properties.

Pension Funds, similar to insurance companies and banks, have a fiduciary responsibility to the beneficiaries of their investments and are often pressured politically to make "socially responsible investments."<sup>20</sup> With their fiduciary responsibilities, plan managers must consider risk and yield first. Two important items that must be given consideration are diversification and competent asset management.

## **SUMMARY**

The real estate industry is in the process of mending the "wealth" of the 1980's and the shifting U.S. investors' traditional attitude to convert long term value into short term profit. At the end of the 1980's, developers were ambitious with their perception of different real estate market's development needs. This helped cause the overbuilding of the real estate markets and eventual downfall of the industry. The 90's will be a time when everyone in the real estate industry must work hard to create value and be more patient for the longer term outcome. Real estate assets have lost tremendous value and competition in the marketplace has increased dramatically.

Historically, pension fund and institutional investors have entered the real

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<sup>20</sup>Louargand, Marc A., "Pension Fund Investment in Housing", MIT Center for real Estate, Working paper #34, September 1991, p. 2.

estate arena as passive investors. During the 1980's, these entities found themselves as active participants through reversion of ownership via default, foreclosure, and bankruptcy. Due to their historically passive roles in real estate, the pension funds and institutions do not necessarily have the expertise to actively manage their assets. The focus as a pension fund is to provide a venue for employees to increase their retirement holdings for future needs. Pension funds have a different responsibility to their investors due to their sources of investor funds. Insurance companies and banks utilize the funds of depositors and premium holders for their investments. Both are looking for a profit. These individuals are principally concerned with the availability of their funds when needed, whereas pension participants are looking for increasing their returns in the future and have a specific concern for the success of the fund's investments. The most important characteristics that institutional investors and pension funds share is their need to access their funds on fairly short notice.

The institutionalization of the real estate industry will continue as most properties and portfolios are being pooled into pension investments, REITS, or reverting back to institutional lenders through default. These circumstances create an increased need for excellent asset and property management. It is important to attract and retain solvent tenants who will fit the property's needs for the long term. Service quality will also assist in the retention of tenants as leases roll over.

## CHAPTER 2

### ASSET AND PROPERTY MANAGEMENT

#### Historical Perspective

Traditionally, real estate management was thought of as only on-site property management. There are generally two categories of "real estate management": standard real estate property management and asset management. The traditional duties of the standard property management include the basics of running a property - processing payments, coordinating maintenance, and producing a monthly operating statement. In comparison, asset management provides a broader spectrum of responsibilities. These responsibilities bring to light the process of adding value to an asset and formulating an overall strategy to increase the cash flow over the term of ownership. The distinctions between the two are summarized below:<sup>21</sup>

<b>PROPERTY MANAGEMENT</b>	<b>ASSET MANAGEMENT</b>
<ul style="list-style-type: none"><li>• Maintenance and facilities management</li></ul>	<ul style="list-style-type: none"><li>• Value enhancement</li></ul>
<ul style="list-style-type: none"><li>• Monthly operating statement preparation (profit/loss statements: aged accounts receivable statements, cash receipts, balance sheets, rent rolls, sources and uses)</li></ul>	<ul style="list-style-type: none"><li>• Real estate management selection and supervision</li></ul>
<ul style="list-style-type: none"><li>• Tenant billings and collections (base rent, rental increases, common area expenses, percentage rents, reconciliation's)</li></ul>	<ul style="list-style-type: none"><li>• Project cash flow and financial feasibility analysis</li></ul>
<ul style="list-style-type: none"><li>• Expense disbursements</li></ul>	<ul style="list-style-type: none"><li>• Market trends and conditions monitoring</li></ul>
<ul style="list-style-type: none"><li>• Vendor selection and supervision</li></ul>	<ul style="list-style-type: none"><li>• Leasing strategy formulation</li></ul>
<ul style="list-style-type: none"><li>• Tenant relationships</li></ul>	<ul style="list-style-type: none"><li>• Property business plan preparation and execution</li></ul>
<ul style="list-style-type: none"><li>• Lease provision enforcement</li></ul>	<ul style="list-style-type: none"><li>• Property debt and equity restructuring</li></ul>
	<ul style="list-style-type: none"><li>• Proforma preparation and analysis</li></ul>

<sup>21</sup>Karras, Stath, "Real Estate and Asset Management in the Investment Cycle", *The Real Estate Finance Journal*, Spring 1990,p.87.

In general, asset management is an on-going process of creation and maintenance of value in the property over a period of time. As compared to standard property management, asset managers often have the responsibility of numerous properties, while property managers are very localized and property-specific. In summary, the asset manager is responsible for the investment strategy development and performance; the property manager executes the day-to-day management, leasing, marketing and/or redevelopment plan.

Historically, developers oversaw the service of property management and determined whether to hire an asset manager. In the past, the institutional investor's role would end at the close of the financial arrangements. The only connection with the property was the lending. Institutions would have a portfolio manager, who oversaw their entire portfolio and analyzed the performance of all investments in the portfolio in relation to each other. There was not a designated real estate specialist within most institutions ten years ago.

### **CHANGES IN ASSET AND PROPERTY MANAGEMENT**

The trend of property and asset management is towards greater sophistication, better standards of performance assessment, and increased competition in the marketplace. The owners of the properties are becoming more sophisticated in comparing and tracking performance and expect greater analysis and reporting from the management. They are looking for a management team's ability to work together, acknowledge any mistakes immediately, and provide an honest assessment of the property and the market.

## **Changes in Asset Management**

The roles and responsibilities of the asset manager have become increasingly sophisticated. The asset manager role is to strive to increase value by analyzing clients' investment strategies and by comparing properties with those of the competition in order to maximize the profits. An overall investment strategy must be developed and implemented by examining the past and present performance of properties in the portfolio and within the marketplace. Future trends need to be anticipated and leasing/management patterns adjusted to adhere to any changes. Asset managers are responsible for long-range decisions on tenant retention refinancing and sale of the properties. In addition, they are responsible for the day to day capital decisions and long term leasing strategies.

The asset manager's new role can be broken down in all four periods of the investment cycle which include conception, absorption, investment (portfolio management process), and disposition. In the past, all development and re-development decisions were made by the owner with the recommendations of the contractor, architect, engineers, landscape architect, marketing director, finance specialist and leasing agent. The asset manager now contributes pertinent information to this team of specialists at various times during the investment cycle, including:



**ASSET MANAGER CONTRIBUTIONS**  
**During Conceptual Development<sup>22</sup>**

- Acquisition - Participate in review of acquisition candidates; review performance projections; and assess future retenanting rehabilitation.
- Make certain that the project will be desirable (and therefore marketable) to the target market in terms of comfort, efficiency, and aesthetics. This includes everything from the landscaping to the HVAC system
- Assess the long term cost effectiveness and efficiency of materials and systems from a maintenance point of view.
- Suggest practical energy-management systems.
- Review the administrative aspects of leases
- Develop an expense pro forma.

As a part of the acquisition process and future responsibility to oversee the performance of the property, the asset manager must be very involved in the conceptual phase. First, the project must make sense in the market and for the targeted users. This includes the construction and operations of the building. In order to perform management duties, the asset manager must understand the building blocks of the property. The pro forma is an important measuring tool in later phases of the ownership and must be carefully formulated by the asset manager in relation to future performance and necessary capital expenditures. The next step in the cycle is absorption:

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<sup>22</sup>Karras, Stath, "Real Estate and Asset Management in the Investment Cycle", *The Real Estate Finance Journal*", Spring 1990, p.88.

**ASSET MANAGER CONTRIBUTIONS  
During Absorption Process<sup>23</sup>**

- Review of standard lease agreements for practicality of application and enforcement.
- Review and approve of all individual tenant leases before final execution.
- Coordinate tenant move-ins.
- Monitor tenant improvements.
- Prepare long term capital expense budgets.
- Create and monitor operating expense budget.
- Fine-tune all building systems.
- Select and supervise on-site manager.
- Set up maintenance team and systems.
- Contribute to leasing and marketing efforts.

During the absorption process the asset manager must ensure there is excellent on-site management to oversee the day-to-day operations. In this competitive environment, the most important aspect for the success of developments is the ability to work as a team and to produce the most cohesive environment for the tenants. The asset manager must understand each individual lease, know what was involved in the different buildouts and how the tenant fits in with the tenant mix of the property. The asset and property manager are visibly an important aspect to this cycle of the investment. The next cycle is the investment, portfolio management process, in which the property is up and running.

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<sup>23</sup>Ibid.

**ASSET MANAGER CONTRIBUTIONS  
During Portfolio Management Process<sup>24</sup>**

- Prepare aggressive budgets and a business plan. Perform regular strategic review of properties potential.
- Monitor day-to-day management operations.
- Keep expenses at a minimum without deferring maintenance.
- Ensure good tenant relations and make periodic visits to the site.
- Monitor local and national market conditions.
- Design and carry out planned retenant/rehab.
- Analyze/appeal property tax assessments.
- Design new financing to reduce equity

Through the aforementioned contributions, an asset manager may make a significant difference in the value of the cash flow. By keeping expenses low and revenues up to date, the investors will receive a good return on their investment. Disposition or repositioning of the property is the final stage of the cycle.

**ASSET MANAGER CONTRIBUTIONS  
During Disposition Process<sup>25</sup>**

- Make a concerted effort to reduce operating expense.
- Collect income aggressively.
- Provide accurate historical accounting and maintenance information.
- Provide due diligence information.
- Restructure owners:
  - Consider sale/lease of partial/total ownership.
  - Evaluate buyouts in joint ventures.

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<sup>24</sup>Ibid., p. 89.

<sup>25</sup>Ibid.

The asset manager will handle the disposition or repositioning of the property. The role of asset management has become an integral part of the real estate industry. With the changes in the industry, the institutional owners now have to consider the hiring of an asset manager instead of depending on the developer to handle all management processes. Overall, in hiring an asset management company, an institutional investor will look for the following qualities in the firm:

<b>NEW EXPECTATIONS IN ASSET MANAGEMENT<sup>26</sup></b>
<ul style="list-style-type: none"><li>• In-depth market knowledge</li><li>• Stronger communication and interpersonal skills</li><li>• Look for firms with the strongest reputations - proven track records</li><li>• Want timely, accurate and complete accounting reports</li><li>• Flexibility to use institutions chart of accounts and management information systems</li><li>• Budgeting, tenant retention, leasing</li><li>• Selectivity in investments</li><li>• Asset managers must meet the clients' philosophies and needs</li></ul>

### **Changes in Property Management**

The increase in responsibilities for the asset manager has greatly affected the role of the property manager. In today's real estate markets, some companies have enhanced the property management position to include many responsibilities of asset management in order eliminate unnecessary layers in the management process. There is a greater sophistication expected along with better standards of

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<sup>26</sup>Ibid.

performance from the property manager as well as the asset manager. The best way to rate a project's individual performance is to compare it against its competition, the economy, the demographic changes and performance standards achieved by others in the marketplace. Owners must be able to track and analyze this information regularly. How they do this is part of the new property management role. The following is a list of the most important property management documented in an industry wide study conducted by Arthur Andersen for IREM:<sup>27</sup> The list represents the priorities as a consequence of the greater complexity and sophistication that is apparent in the institutional ownership of real estate in the 90's and into the future.

<b>NEW RESPONSIBILITIES FOR PROPERTY MANAGERS</b>
<ul style="list-style-type: none"><li>• Retain Tenants</li><li>• Negotiating leases/tenant improvement</li><li>• Management/strategic planning</li><li>• Prepare financial reports</li><li>• Decisions about acquisitions/ dispositions</li><li>• Budget</li><li>• Tenant relations</li><li>• Property administration</li><li>• Monitoring performance</li><li>• Decisions about development/redevelopment</li><li>• Project feasibility analysis</li><li>• Physical plant/maintenance</li></ul>

### **Summary**

Institutional owners look for professionalism in all relationships. This places an emphasis on professionals with advanced degrees and recognized industry credentials. They are looking for a CPM (Certified Property Manager) for

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<sup>27</sup> Arthur Andersen Real estate Services group, Managing the Future: Real Estate in the 1990's, IREM, 1991

management, CCIM to assist in leasing, and CPA's for better in-depth reporting capabilities. According to a study presented in the Journal for Property Management: "The value of the designated manager may be evident in several areas, including better ability to recognize the needs of tenants and greater creativity in marketing. While professionalism is not the only factor affecting rents, it clearly has a positive effect. The industry is based on relationships and these relationships must boast mutual trust."<sup>28</sup> Overall, property and asset managers have more experience and have a stronger educational background than they did ten years ago. Many companies are utilizing training programs that provide these managers with the skills to out-perform the competition.

### **INSTITUTIONAL USERS OF ASSET AND PROPERTY MANAGEMENT SERVICES**

Institutions are now the largest users of asset and property management professionals. With the reversion of real estate to the institutions, they now have the responsibility to handle management and operational aspects of the properties. The scope of the problem is of great concern for all investors. Institutional investors have \$114 billion of non-residential real estate, and financial institutions have \$101 billion of non-residential real estate. The institutional owners are most concerned with the fact that these portfolios contain many poorly performing properties, which need the greatest attention. Asset management services will be demanded most heavily in office buildings. This is primarily due to the large surplus of office space available, and because it is the property type that has

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<sup>28</sup>Sirmans, C. F. and Sirmans, Stacy G., " The value of Professional Asset Management", *Journal Of Property Management*, January/February, 1992, p.53.

experienced the greatest devaluation. It is estimated that institutional owners have anywhere from 60 - 100% of their portfolio in non-residential properties, including office, retail, warehouse, hotel/motel, and industrial.

Both pension fund and institutional owners are wary about investment in real estate. As mentioned above, they will be more prudent and sophisticated in monitoring their investments. As a result of the poor economic conditions, many properties they currently hold are distressed and need the attention of personnel that can provide a plan that will successfully enhance the property and implement plans effectively. Each property must be managed based upon long range physical, marketing, and financial issues. There must be an understanding and agreement between the owner and the management on the strategies for individual properties and the portfolio as a whole. Creative and proactive managers are needed in order to provide consistency and superior overall service.

Distressed properties require considerable attention in order to regain their presence in the market. In order to effectively manage these properties, managers must be able to respond immediately to tenant problems. Depth within the management ranks will provide the managers with resources to efficiently and effectively address every problem they confront. The bottom line is also important, including sensitivity to the entire operation, preventative maintenance and prudent purchasing. The ultimate goal of any investor is return on investment. Therefore, properties need to provide value to the institution, and in turn provide the tenants with quality service.

In order to address the change from a passive financing source or investor to an

owner/operator position, certain expertise is required to manage all aspects of the assets. Along with other institutions, pension funds have put new pressures on the asset manager as a result of their disillusionment with real estate. Fund sponsors are demanding more participation and a more active role in the decision making process as well increased control over the asset management role. The pension fund's sponsors feel they must protect themselves, because they have found outside asset management unreliable in protecting their best interests. Some investors felt that management entities were more concerned over their fees than the best interest of the investors and question the re-structuring of fees as an incentive for asset managers to maximize value. Another way to give management companies an incentive to maximize the value of an asset is through equity participation. As Blake Eagle states, " Manager's capital should be at risk. If an investment is good enough for pension funds, it should be good enough for managers."<sup>29</sup> The pension funds' focus is to create a partnership with the asset managers rather than giving full autonomy to a management company. Although the preceding information came from pension fund sources, it is similar with all institutions. Generally, the asset manager is the owner representative and can provide insight in management decisions. It is important to have a management team that has the qualities and ability to relate to the ownership role effectively enough to take on the responsibility of ownership, not just part of an outside management team.

A study published in the July-December edition of Fleet's Guide - Income Property Financing Sourcebook showed the following preferences of 104 insurance companies and pensions funds in future investment in real estate:

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<sup>29</sup>Newman, Morris, "New Demands from Pension Fund Investors", *Journal of Property Management*, September/October 1992, p. 53.



PROPERTY TYPE	% WHO WOULD INVEST <sup>30</sup>
Warehouse/Distribution	92.3%
Strip Retail w/anchors	73.1
Garden Apartments	66.3
Medical Office	63.5
Single-Tenant Office	62.5
Multi-Tenant Office	60.6
Owner-Occupied Office	60.6
Light Manufacturing	46.2
Freestanding Retail	33.7
R&D/Flex Space	32.7

These are the statistics for properties institutions will invest in in the future. They will be directly involved in the management of assets that have been foreclosed, but in future investments they will not be involved in the same way. They will be more educated in the management needs of real estate from an owners perspective. Institutions are more sophisticated in real estate and this sophistication is here to stay, whether in ownership or simply investment.

### **ASSET MANAGEMENT AND SERVICE QUALITY**

Recently, the real estate industry has realized the importance of service quality which originated in the manufacturing industry. According to W. Edwards Deming, there are two distinct attitudes between a company that believes in service quality and one that does not. "A standard company believes Quality is expensive, defects are caused by workers, buy at lowest cost, fear and reward are

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<sup>30</sup>Powers, Maries, "Pension Funds Divided on Wisdom of Investing in Real Estate", *National Real Estate Investor*, September 1992, p. 44.

proper ways to motivate and play one supplier off against another. A "Deming" company believes quality leads to lower costs, most defects are caused by the system, buy from vendors committed to quality, fear leads to disaster and work with suppliers."<sup>31</sup> In the real estate industry, especially in this economic climate, companies are trying to cut costs, not increase them. But, it is important to note and understand Deming's point of view and learn from the manufacturing industry. A summation of experts on quality would be defined as: "Quality is always meeting standards that the firm sets based on its customer's needs, at a competitive price."<sup>32</sup> The real estate industry has changed its direction dramatically:

First, absolute growth is no longer the driving force behind the commercial real estate investment market. And second, the power base has done a 180-degree turn from the develop/owner to the tenant/customer. In the world of excess supply, what counts will be long term nurturing of this tenant/customer relationship. It might even be said that during the 1990's real estate will be truly reflective of its categorization as a "service" industry.<sup>33</sup>

In the case of the real estate industry, providing quality service is a pertinent way to compete for tenants. It may cost more to ensure quality, but it results in fewer incurred costs to replace tenants on a regular basis or carry vacant spaces in the property. The following is an excerpt from a SERVQUAL study of real estate brokerage services:

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<sup>31</sup>Aguayo, Raphael, Dr. Deming: The American Who Taught the Japanese About Quality, 1990, p.17.

<sup>32</sup>Segal, Andrew T., "Absolutely Positively Satisfied: What Asset Management Can Learn From The Quality Revolution", MIT thesis, September 1991, p. 19.

<sup>33</sup>Shilton, Leon, "Linking Quality to Incentive Compensation", *The Real Estate Finance Journal*, Winter 1992, p. 58.

The real estate business is generally viewed as a referral and repeat customer business. Satisfied customers give referrals and repeat business. It follows that the goal of a successful real estate agent should be a satisfied customer.... We find that customers are concerned with reliability foremost.<sup>34</sup>

According to Deming, quality must come first: "...increasing quality leads to higher productivity, lower costs, higher profits, higher share price and greater quality service for everyone in the company-the managers, the workers, and the owners."<sup>35</sup> In asset management, by spending money up front on capital expenditures, certain operating expenses can be decreased. In addition, aesthetic improvements can increase the attraction of the building to tenants and customers. Money spent initiating a tenant retention program will decrease the amount of money spent on tenant improvements, brokers, lawyers, and loss of income due to lease-up and build-out. Quality management produces fewer defects and lower costs. Service quality is one of the main issues in asset/property management. The service to both the tenant and the owner is of great consideration in the success of a third-party management company.

### **Definition of Quality**

Quality has to be considered from the point of view of the user. Deming expands on this summary of quality:

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<sup>34</sup>Suffolk University, "Real Estate Brokerage Service Quality: An Examination"

<sup>35</sup>Ibid. p. 19.

Quality can be defined only in terms of the agent. In the mind of the production worker, he produces quality if he can take pride in his work. Quality to the plant manager means to get the numbers out and to meet specifications. The difficulty in defining quality is to translate future needs of the user into measurable characteristics, so that a product can be designed and turned out to give satisfaction at a price that the user will pay. What quality characteristics are important to the customer? The quality of any product or service has many scales. Product put on the market today must do more than attract customers and sales: it must stand up in service.<sup>36</sup>

In a study performed in the restaurant industry, key factors are explained as: "assurance, empathy, responsiveness, reliability, and tangibles."<sup>37</sup> These factors can be related to the real estate industry. Asset managers and owners alike, need to focus on similar factors:

**Reliability** - Asset managers will ensure that the property will be run smoothly. The asset manager has prior experience.

**Responsiveness** - Asset managers will help the property managers and tenants on leasing and budget questions. They will explain any uncertainties related to the parameters enlisted by the owner.

**Assurance** - The asset manager will develop a strategic plan that will enhance the value in the property. The asset managers will be clear in the directions given to the property management to operate the property.

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<sup>36</sup>W. Edwards Deming, Out of Crisis (Cambridge: MIT, Center for Advanced Engineering Study, 1986)p. 168.

<sup>37</sup>McDaniel, J.R., "An Empirical Study of Service Quality in the Food Service Industry", Suffolk University, School of Management, p.10.

**Empathy** - Asset managers will know the needs of their tenants and property management.

**Tangible** - The asset manager will ensure that the property manager has full control over keeping the property clean and all equipment operating properly. The facilities will remain at a comfortable temperature.

Within the real estate industry, tenants and owners are the customers who purchase a bundle of real estate services, "The better the service package provided, the more desirable the product becomes, and the greater the value of the real estate."<sup>38</sup>

The tenant is purchasing space in a building with quality management that maintains the grounds and keeps the building operating competitively in the market. The tenant needs to be treated as a valued customer in order to retain that tenant beyond the initial lease term. The tenants need to be able to conduct their business in an attractive, well maintained, professional environment. The owner is investing in a team of individuals to maintain the building and bring in the highest possible cash flow. The owner also needs the management team to actively pursue ways to improve the value of the building. The most important components to service quality are: "developing a culture of quality; measuring quality; building a quality team."<sup>39</sup> These three components utilize the elements of the survey mentioned above. A culture of quality includes the element of empathy and assurance that the customers needs will be met by the management team who has

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<sup>38</sup>Diserens, John H., "Maximizing Value Through Quality Service", MIT/PREA Presentation, June 29, 1992, p. 1.

<sup>39</sup>Diserens, John H., "Maximizing Value Through Quality Service", MIT/PREA Presentation, June 29, 1992, p. 1.

the experience to operate the property efficiently. Measuring quality ensures that all five of the restaurant survey items are met. Building a quality team means providing reliability and responsiveness.

### **Developing a Culture of Quality**

In order to develop a culture of quality it is important to identify customers' needs, including their preferences and expectations. Two service quality researchers, Karwin and Rosen, conducted a study in 1988 based upon the customers' perspective and expectation in receiving customer service. The survey identified certain attributes that should be emphasized by a company, but focused only on the external forces of the relationship, leaving out the internal management perspective. It showed that in order to develop a general culture, a company must consider both the internal and external forces equally. In real estate, the external factors include the broad financial market, while the internal market represents the internal operations of the project. Asset managers must learn to see and understand the business from a tenant's perspective, owner's perspective, and market perspective. The key to developing this quality structure is through communication. This presents the asset managers with a dual position. First they must follow the same philosophy as the owner and, at the same time, listen to and meet the tenant's needs, in order to provide the optimal climate for both tenant and owner. Customers and tenants alike are willing to voice complaints louder than commendation. It is these complaints that the managers must not only listen to, but react to as well. "When employees understand the meaning of quality, and are trained and equipped to provide it, they will have the confidence to execute it."<sup>40</sup>

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<sup>40</sup>Diserens, John H., "*Maximizing Value Through Quality Service*", MIT/PREA Presentation, June 29, 1992, p. 1.

## Measuring Quality

Measuring performance is difficult given the unique variables of relationships between an advisor, an asset manager, and a property manager. According to Stuart Ackerberg, of The Ackerberg Group, "Depending on the delineation of responsibility between asset manager and property manager, different measurements of service are necessary."<sup>41</sup> The Ackerberg Group places the responsibility for performance on the asset manager. The asset manager must set up performance measures to ensure the property manager is providing quality service. The following is a list of performance measures utilized by The Ackerberg Group:

<b>PERFORMANCE MEASURES<sup>42</sup></b>
1. Confidential surveys sent to tenants regarding property management performance.
2. Monthly variances in budgets, delinquencies, maintenance, service calls, tenant retention, etc., reviewed.
3. Surprise inspections twice a year on all properties by asset managers.
4. Specification manuals provided for custodial maintenance and tenant relations.

"Further, when performance is acknowledged and rewarded by linking it to salary dollars, the firm demonstrates its commitment to the program and rewards

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<sup>41</sup>Ackerberg, Stuart I, "To fee or not to fee; the management debate continues", *National Real Estate Investor*, September 1989, p. 73.

<sup>42</sup>Ibid.

managers who further the firm's goals."<sup>43</sup> According to Leon Shilton, Ph.D., director of GBA Real Estate Research Center at Fordham University, "[The] doctrine of quality espouses that performance should be based on consistent improvements as reflected in the cash flow."<sup>44</sup> Right now, consistent improvements in cash flow are important because they are the leading indicator of external and internal conditions. One way to ensure that employees offer quality service is through compensation. The climate in the industry has shifted away from compensating based upon short term reliance and transaction volumes to the importance of long term operational indicators. Traditionally, the manager/leasing agent would be compensated for a new tenant when that tenant moved in. The compensation would be based upon the lease terms and would be awarded all at once. The new trend is to draw out the compensation over the term of the lease in order to ensure quality tenants and quality management services.

The most important issue to address is quality measurement on both an internal and external basis. Often times, the internal performance standards are being met, but they do not match the standards of the customer or vice versa. Seldom do organizations have matching internal and external measures of service quality. Measuring quality can be done in several ways. Surveys can be distributed on a regular basis, requesting customer feedback on key issues of management. Tenant retention is probably the most visible way to measure quality asset management. The percentage of tenants retained and the reasons for the tenants leaving are good indicators of the strengths and weaknesses of management. The following is a list of implied measures often expressed by tenants:

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<sup>43</sup>Ibid.

<sup>44</sup>Shilton, Leon, "Linking Quality to Incentive Compensation", *The Real Estate Finance Journal*, Winter 1992, p. 58.



### COMMON TENANT DESIRES<sup>45</sup>

- I want urgency in response.
- I [want] good communication.
- I want a landlord who is a good listener-responsive, available, and knowledgeable-and who seeks my input into building decisions.
- [I want a landlord who] listens, cares, and is attentive and who is easy to reach.

Tenant retention is an important measurement of service quality in the real estate industry. There are two ways to look at the role of tenant retention. From the owners' perspective, their goals have changed from "just fill the vacancies" to "keep the 85% occupancy." From the tenants point of view, they do not want to inconvenience of relocation and they would rather remain in places where they are regarded as a valued customer. Tenant retention saves money in operations by eliminating the loss of rent during turnover and the possible tenant improvement requirements upon re-leasing the space. This provides an arena to offer incentives to tenants to remain in their current location. There is such an abundance of vacant space that it becomes a challenge to create space which is better than the next alternative. While tenant retention begins on the date the lease is signed, the management team needs to continually address the tenants' needs and contentment with their location. This is one way to ease the renewal process. Many landlords flood tenants with attention at the commencement of the lease term, but fail to continue communications until three months prior to the end of the lease term.

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<sup>45</sup>Segal, Andrew T., "Absolutely Positively Satisfied: What Asset Management Can Learn from the Quality Revolution.", *Urban Land*, February 1992, p. 40.

## **Building a Quality Team**

The quality service must be consistent throughout all aspects of management. The relationship between the asset manager and property manager is an important factor in maximizing value in an asset. The asset manager must educate, stimulate and motivate the property manager. All contracted services must follow the same dedication to quality customer service as the owner and management firm. These services include accountants, contractors, and maintenance personnel. Hiring the right people is also important. This is true within the management team as well for hiring outside services. Relationships need to be strong between the management/tenant, management/contracted services and management/owner. The real estate industry is a relationship business. The relationship between asset manager and property manager is important to a successful property, "For it is when the property manager is a fully integrated member of the asset management team that he will effectively contribute to the maximization of value."<sup>46</sup>

Owners and asset management companies are prudent in identifying, hiring and training competent people. After acquiring new properties through foreclosure and default, institutional owners will address areas of deferred maintenance by implementing corrective measures. Along with this there is an overall evaluation of the property and new management is brought on board to help revitalize the property.

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<sup>46</sup>Ibid.

## **ROLE OF OUTSIDE PROVIDERS IN ACHIEVING SERVICE QUALITY**

With the changes of ownership of reverting back to the institutional and pension fund investors, there is a need to consider the options for the management of these properties. Should they hire someone to work within the company or outsource to a third-party management company? Should they retain many of the responsibilities in-house and, if so, what are they going to outsource? If they do hire an outside management firm how do they determine what company to utilize? Third-party management is on the rise and is becoming competitive within the industry. There is an abundance of third-party management firms due to the restructuring of development and brokerage companies who are accommodating this change in the market. There are benefits to both third-party and in-house management.

Service quality is the goal of the institutional owners whether they choose to staff up or outsource to service providers. With in-house management there is greater control of the outcome of management, accounting systems are more easily integrated, and there is a consistency in delivery of the service. Third-party management can decrease corporate overhead and can result in higher quality with use of local firms that understand the market, vendors, and customs. The question lies in how the institutional investors select the best asset/property management for their properties. Most are downsizing and do not have the capability or desire to directly control the properties. Some institutions utilize a combination of third-party and in-house management, whether by hiring third-party property/leasing management and retain the asset and portfolio management within the company or any other combination.

### **In-House Asset Management**

Traditionally, lenders are accustomed and prefer in-house management, according to Paul Chapman, senior vice president and manager of asset management at Heller Financial, "from a lender's perspective, the preference would be for the owner/borrower to manage the property because they have a vested interest in the long-term economic viability of the project. However, if the owner/borrower lacks the hands-on expertise to effectively manage a property [as in the case of properties reverting back to investors and lenders], we would prefer the property to be managed by an experienced third party management firm."<sup>47</sup> Heller Financial's experience with institutional owners has shown that, institutional owners will only outsource for properties outside their geographic area, limited responsibilities, or for a property type where they lack expertise. Other indicators in this decision are property size, potential conflict of interest and management intensive properties.

"Several institutions and pension advisories feel it is their fiduciary responsibility to manage their assets in-house. David Glickman of Heitman Advisory Group notes: 'If the owner is on-site, the property management performance will be greater than the median, where the median is property management services provided by a third-party agent.'"<sup>48</sup>

The following is a compilation of potential benefits and costs to retaining in-house asset management, from a study performed by Arthur Andersen and a study

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<sup>47</sup>Nichol, Fran, "Third Party Management Emerges", *National Real Estate Investor*, April 1992, p. 42.

<sup>48</sup>Ackerberg, Stuart I., "To fee or not to fee; management debate continues", *National Real Estate Investor*, September 1989, p. 73.

published in National Real Estate Investor by Stuart Ackerberg.<sup>49</sup>

Potential Benefits to Retaining In-House Asset Management	Potential Costs to Retaining In-House Asset Management
1. Allows owners complete management control of assets as well as outcome	1. Build up of potential staff causing an increase of overhead and is not an option at times of reduced income and consolidation.
2. Lines of communication are shortened	2. The problem of hiring staff is that their employment responsibilities will eventually work themselves out of a job.
3. Priorities will be assigned in accordance with management's wishes.	3. Compensation and incentives may have to vary from normal salary structure.
4. Accounting systems are more easily integrated. Utilization of their own programs.	4. Personalities may clash with corporate culture.
5. No fee incentive	5. Management's time will be diverted from the principal goal of creatively investing the pension fund or institution's assets.

In order for in-house asset or property management to make sense, enough square footage must be acquired in a certain marketplace so the economies of scale can be realized. Owners will hold onto different aspects of asset management depending on the cost benefits to retaining or outsourcing. They feel this will provide a better atmosphere to create overall service quality in the management of their assets. Services of less importance to an owner will be farmed out to a service provider. According to Richard Mastain, of The Prudential Asset Management Company, "By utilizing third-party managers, we are allowed to

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<sup>49</sup> Arthur Andersen Real estate Services group, *Managing the Future: Real Estate in the 1990's*, IREM, 1991, p. 160. and Ackerberg, Stuart I., "To fee or not to fee; management debate continues", *National Real Estate Investor*, September 1989, p. 73.

focus on the asset rather than managing the people."<sup>50</sup> In addition, the capital requirements associated with providing in-house services is substantial, including additional personnel, training and education, relocation, recruiting and supervision, so it is more beneficial to outsource the property management. What services can be outsourced and what should remain in-house?

### **Out-Sourcing**

There are several reasons some institutional owners do not want to take on property management. The first is economic: especially with retail, where there is too great an ebb and flow from the standpoint of ownership, because they are going to buy and sell. When owners sell, what will they do with the staff hired for those properties? Where it is not feasible to retain a staff during a disposition process, it makes more sense to staff up internally and outsource the property management. Another factor of hiring a third party management company is the benefits of additional services available in addition to just management. There is also a better chance to create an atmosphere of service quality. Property management always (but especially in economic down times) calls for more responsive aggressive and entrepreneurial behavior. The entrepreneurial behavior of a property manager can push a conservative institutional owner into new innovative ventures in management that may cut costs, help retain tenants or attract customers. The following was compiled from a study performed by Arthur Andersen and a study published in National Real Estate Investor by Stuart Ackerberg.

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<sup>50</sup>Ibid.

### **Benefits to Out-Sourcing Property Management<sup>51</sup>**

1. The management team is independent and has experience working together which will provide quicker results. Adjustment time to a property will be shorter.
2. The incentive and salary structure can easily differ from the normal corporate structure.
3. An entrepreneurial type staff would be difficult to hire into a corporate structure.
4. Incentives are easy for a goal-oriented approach.
5. Problem properties would be more insulated from day-to-day investment activities.
6. Quality can be greater due to local knowledge - understanding of market, vendor, customs...
7. A management company eliminates the need for excess staff, space, or other overhead.
8. Outside firms have more pressure to perform due to the tremendous amount of competition for contracts.
9. Institutions gain organizational flexibility.
10. Owners don't want to be in property management business.

In addition to the aforementioned, property/asset managers can be contracted for a specific range of activities to best fit the needs of the institution. For a fee they work quickly and effectively until the project is completed, at which point they are disengaged until the institution needs their services again. This allows the institutions to limit their management/consulting fees. With the changing market, some institutions want to retain control. By having the option to use service providers, they have the ability to staff up when needed without a long term commitment. This gives the flexibility to find experienced managers for their properties.

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<sup>51</sup> Arthur Andersen Real estate Services group, Managing the Future: Real Estate in the 1990's, IREM, 1991, p. 160. and Ackerberg, Stuart I., "To fee or not to fee; management debate continues", *National Real Estate Investor*, September 1989, p. 73.

Institutional owners are retaining a certain level of expertise in-house and farming out the rest to service providers. They are demanding a greater role in the decision making process and, overall, are much more involved in the property performance. Through utilizing service providers, many institutional owners believe they can gain the best quality service for their properties. In this market, it appears that with the importance placed on institutional downsizing, their limited operating knowledge of their real estate, and the distressed state of most properties, pension fund and institutional owners would benefit from out-sourcing. Yet, after the troubles of the 80's, institutions want to have tighter control of their properties. In response to hesitation of institutional investors to outsource, several companies have provided both asset and property management services for one fee. John J. Moynihan, Vice President of Copley Real Estate Advisors, describes the pull to in-house property management: "When our property managers go home in the evening, they think about the project. This isn't the case with other third-party managers. We want our partners tied into the performance of the asset. Therefore, we only allow market management fees and demand intense property management to create long-term value."<sup>52</sup> In summary, there is a sense that the roles of asset management and property management have changed. It appears that the role of property management is combined with certain traditional asset management responsibilities and the role of asset management includes more of a portfolio management role. This is caused by the higher demands of the marketplace. The institutional owners are demanding more from both roles. Therefore, there must be tight coordination and integration of the roles. Chapter three addresses the demands of the institutional owners.

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<sup>52</sup>Ackerberg, Stuart I., "To fee or not to fee; management debate continues", *National Real Estate Investor*, September 1989, p. 73.



## **CHAPTER 3 - INSTITUTIONAL OWNERS RESPOND TO THE CHANGING MARKET**

By the end of 1991, the total value of U. S. commercial real estate, estimated at about \$3.5 trillion in 1989, had declined by approximately 30% - a loss of about \$1 trillion.<sup>53</sup> This is close to twice the dollar amount lost in the crash of the U. S. stock market in October 1987. There continues to be much speculation as to when the market will turn around, but the fact remains that currently there are unwilling owners of distressed real estate struggling to minimize their losses and bring value back to their \$69 billion investments.

Institutional owners are feeling the pressure of the distressed real estate market and overall macro-economic market in different ways. Many insurance companies are confronted with insolvency. Banks are failing; thrifts are being taken over by the RTC. All institutional owners are faced with illiquidity of their real estate holdings due to declining values, high vacancies, and difficulties obtaining money. Each type of institutional owner deals with the situation differently.

To document these distinctions in this research, a questionnaire was formulated on the current strategies of banks, insurance companies, and corporate pension funds, their decision process for staffing up or outsourcing asset and property management, emphasis on responsibilities of the management of both asset and property managers, and how they measure the quality of services provided. This chapter presents the results derived from nineteen interviews. All

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<sup>53</sup>Loomis, Carol J., "Victims of the Real Estate Crash," *Fortune*, May 18, 1992, p 70.

have been faced with the acquisition of properties through foreclosure.

## **RESPONDENT PROFILE**

Exhibit one provides a profile of the companies interviewed for this research. By looking at exhibit one, it is clear that the portfolio strategies of each organization are dependent upon their principal means of business. In general, participants are currently disposing of all distressed properties, or a portion of the portfolio and retaining the balance for repositioning. Four of the ten insurance companies interviewed are acquiring more real estate, along with all three of the pension funds, while all the banks interviewed are disposing their entire portfolio of foreclosed properties. The six banks that participated in this questionnaire have been mandated by federal regulatory agencies to dispose of all real estate taken back through foreclosure. Overall, these institutions are finding themselves as sole owners of distressed real estate that has reverted back to them through non-performing loans. All respondents have found that the ownership of distressed real estate has forced them to create a separate real estate department to handle these properties. If they already had a real estate department, they reorganized it to accommodate the need for increased attention on the foreclosed properties. Most of the real estate departments now focus on asset and portfolio management with the emphasis on the handling of the disposition and restructuring of portfolios.

In relation to managing their current portfolios, most participants were grappling with what properties had potential and should be retained and what properties needed to be disposed of immediately. About 75% of the respondents

hold portfolios with a majority of office buildings. All respondents held almost exclusive portfolios of commercial properties. This dominance of office buildings in the portfolios is directly related to the degree of difficulty they are experiencing in their real estate investment.

<b>RESPONDENT PROFILE</b>			
	<b>INSURANCE COMPANIES</b>	<b>BANKS</b>	<b>PENSION FUNDS</b>
<b>Size of Real Estate Dept.</b>	Ave. - 100 Range 5 -300	Most. - 50 Range 5 - 400	Ave. - 30 Range 6 - 50
<b>Size of portfolio (Real estate equity)</b>	\$200M - \$11B 3-30% of total portfolio	\$100M - \$7B 5-30%	\$7B - \$28B 8-40% of total portfolio
<b>Type of properties in portfolio</b>	Predominantly office, then in following order - retail, industrial, warehouse, some hotel, apt., and multi-family	Three hold all types, others have in following order: office, retail and industrial	All three mostly office, some retail and industrial - looking into residential, and R & D
<b>Strategies</b>	Work through current distressed portfolio - retain assets that have opportunity to regain value. Approx. 40% are acquiring	All in disposition phase as mandated by Federal Government	Working through distressed properties - Acquiring more properties and continuing mortgage loans and MBS

## **INSURANCE COMPANIES**

### **Organizational Structure**

Of the ten insurance companies interviewed all have separate real estate departments with the size of their departments corresponding to the size of their portfolios. By looking at exhibit one, the range of the portfolio is \$200 million to \$11 billion and the real estate department range is 5 to 300. All of the respondents retain several professional asset managers and portfolio managers to manage the demands of restructuring their real estate portfolios. Some have additional professional representation in the areas such as law, construction, property tax, and environmental analysis. These additional personnel typically oversee the process of enlisting related professionals on each particular property, when needed. A few respondents have access to the corporate law department to advise on contracts, leases, and the hiring of counsel at the local level when needed. All respondents outsource property management, with one insurance company interviewed in the process of developing their own property management division as a separate company.

### **Current Portfolio Status**

The insurance companies interviewed are in unique positions due to the state of the real estate market as well as the size and diversification of their portfolios. Of those interviewed, most had 40% or more invested in commercial office buildings. Overall, the entire group of respondents had a majority of their investments in commercial property, such as office, retail, industrial, and warehouse. The large portfolio holders of office buildings tend to have a greater urgency to dispose of a larger number of troubled properties. All insurance

company respondents are retaining their properties until they regain value, Of the insurance companies interviewed, the real estate holdings ranged from 3% to 30% of their total investment portfolio. For companies at the upper end of the spectrum, executives expressed a greater concern of insolvency.

### **Portfolio Management Strategy**

Just over half of those interviewed are focusing on disposing a large portion of their real estate assets, while only four are actively acquiring properties in this down market. These four see the down market as an opportunity to acquire more assets at lower prices. They look for properties in markets that are turning around and have potential for enhancement of value or locations where they can create a niche. Some of the companies interviewed have set a hurdle rate which must be met before they will invest more money into a property or retain it in their portfolio. All properties that do not meet this hurdle are disposed of as soon as possible. The companies interviewed that are currently focusing only on disposition will continue to do so for at least the next five years and will be unlikely to reinvest in real estate in the near future. The remaining companies will work through their troubled properties and acquire at the same time. Most of the insurance companies interviewed do not see any reason to discontinue investing in real estate through joint ventures, mortgages, or equity investments.

## **BANKING INSTITUTIONS**

### **Organizational Strategy**

Of the five bank related participants interviewed, all have set up separate real estate departments within the past three years to handle disposition of all foreclosed assets. The departments range in size from five to four hundred. Most

of the banks have departments of close to 50. In all cases, the departments consist only of asset managers who contract out for the balance of services needed for their assets such as property management and brokerage.

### **Current Portfolio Status**

All the banks interviewed have been recently overwhelmed with non-performing loans from bankrupt developers across the country. Under the Federal Government regulations, they are required to dispose of these defaulted properties, although none of the participants interviewed had a mandated date of disposal. Most of the banks that participated in the questionnaire are strong enough to hold onto the properties long enough to await better values in anticipation of limiting their losses. One of the executives interviewed commented that many banks do not have the luxury to wait for better values and must dispose of their real estate holdings immediately in order to stay solvent.

### **Portfolio Management Strategy**

The range of portfolios involved in this survey is \$20 million to \$7 billion. All participating companies are willing to put money into the properties to help regain value and in order to limit or negate actual losses, but the end result is disposition. The banking executives interviewed will only get involved in acquiring real estate for their own use as a bank branch. They generally own and manage their own branch offices that are either free standing branch offices or larger buildings with the capacity to accommodate other tenants. All banks interviewed are hesitant of getting involved in real estate in the short term.

## **CORPORATE PENSION FUNDS**

### **Organizational Strategy**

The total number of employees of the real estate departments for these three companies ranges from 25 to 50 total employees, with an average of about 30 professionals and support staff. The real estate department consists of personnel that handle acquisitions, dispositions, and asset management.

### **Current Portfolio Status**

Of the three pension funds interviewed all are planning to reinvest and hold most of their current properties for future returns. The pension fund and insurance company respondents tend to retain assets that are located in the largest and strongest markets or in markets that have the best opportunity to rebound in the near future. The pension fund participants have anywhere from 8% to 20% of their total portfolio in real estate. The pension fund executives interviewed have primarily invested in CBD and suburban office buildings with some retail and industrial. The square footage ranges from 40,000 square feet to over 600,000 square feet. Two of the respondents have expanded their investments into residential and R & D.

### **Portfolio Management Strategy**

The three pension fund respondents are currently acquiring real estate in non-residential property to diversify their portfolios. As mentioned in chapter two, many experts in the real estate industry believe that non-commercial properties react differently to commercial properties, thus provided a balancing factor to the portfolio<sup>54</sup>. All respondents confirmed the findings of this study.

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<sup>54</sup>Louargand, Marc A., "Pension Fund Investment in Housing", MIT, Center for real Estate, working

## Summary

Banks and insurance companies have been involved with investment in real estate for several decades, whereas pension funds have only entered the real estate arena in the past decade. All participants are striving to form a management unit for their real estate, that will create the best quality management and bring the most value to the properties. For this reason all participants have started to create a culture of quality in their organization by creating a real estate department for better control over their assets. This culture of quality will improve communications between owner and on-site management. All institutional owners interviewed retained the role of asset management in-house. The reasons for maintaining the asset management in-house, however, varies across the industries. The bank respondents feel they need a representative from the bank to determine the important strategies required by the federal reserve in terms of disposition. There is also a concern of proprietary information getting beyond the confines of the bank. Insurance companies interviewed feel that management companies are just getting involved with asset management and they do not have the expertise to oversee all institutionally-owned assets. Secondly, they feel an outside asset manager would not understand the institution strategies and policies. In all cases, the investors retain internal control in salvaging property and maximizing portfolio value.



The insurance companies have been involved in real estate for many years. This has provided them with more insight on what they need in terms of internal personnel. The larger portfolio holders in the insurance industry tend to have a decentralized real estate department. They have more real estate to dispose of and have set up regional offices to better address the individual management needs of the properties in the portfolio. The banks have a smaller real estate department to simply create and administer the lines of communication between property management and owner. They are eventually disposing of their entire portfolio and do not have the need to staff up for long term management of their real estate portfolio. The pension funds are more recent investors in real estate and are in the process of creating an appropriate staff to fit their needs. Currently their staff is fairly small and centralized. They do not feel the need to have a large staff and depend more on outsourcing most of their needs. This is primarily due to their beneficiaries that practice some control over the investment of the pension fund dollars. All respondents are willing to invest money in their real estate assets if it makes sense financially and strategically. They all seek to build quality management and create value in their assets.

## **THE CREDENTIALS AND RESPONSIBILITIES OF ASSET MANAGEMENT**

### **OVERVIEW**

As mentioned in chapter two, the demand for asset management is fairly new to the real estate industry as a whole. All respondents have retained a bundle of duties internally, identified as asset management responsibilities. They all utilize in-house asset managers as the liaison between the third party management

company (in most cases) and the owner. Each type of institutional owner has different strategies, thus they also have different expectations of the asset managers.

## **THE INSURANCE COMPANY'S PERSPECTIVE**

### **Credentials**

All respondents feel that their organizations have strict internal and regulatory standards to consider in all aspects of real estate investment and operations. There was a consensus among the insurance companies, on the credentials desired in hiring asset managers and reasons for retaining a form of asset management in-house. The insurance company executives feel internal staff will know and understand what is needed from the owner better than any outside management firms. In addition, with the distressed state of many of their portfolios, they want a representative of the owner involved closely with the property. With large and diverse portfolios, the individual must bring an MBA and/or a very strong real estate background to administer the different requirements of varying property types. In addition, the individual must have strong financial and analytical skills to acquire, dispose of, or maintain various assets.

### **Responsibilities**

Insurance companies emphasized the following responsibilities in asset management. They are listed in corresponding order of importance by the participating companies.

<b>INSURANCE COMPANIES ASSET MANAGEMENT RESPONSIBILITIES</b>
<ul style="list-style-type: none"><li>• Develop a business plan and strategy</li><li>• Hire and monitor the best local property management firm</li><li>• Provide appropriate direction and training to the property management</li><li>• Financial analysis and appraisal</li><li>• Implement institution strategies</li><li>• Maximize the value of the property</li><li>• Monitor cash flow - capitalize income</li><li>• Stabilize income</li><li>• Anticipate market trends</li><li>• Advise on disposition and acquisition</li><li>• Perform due diligence</li><li>• Coordinate appraisals</li></ul>



Not all insurance companies are currently acquiring, but all participants have sizable portfolios. The majority of these assets are to be held for an indefinite period while markets recuperate. With this strategy, it is important for these organizations to tailor property strategies that ensure good management is on-site. Since the properties are to be held for a longer term, the asset managers must also have some construction expertise in instances where a property will undergo a renovation or rehabilitation. There is also a greater importance in the longevity of the leases in each property. To obtain long term value, tenant retention and cash flow stability must be achieved.

According to one of the respondents, it is difficult to measure value-added to a property by an asset manager, due to the distressed condition of the property and the overall economic conditions. One could measure added value by the increase of income, but there are other ways that value could be added without

immediate reflection in income. Correcting deferred maintenance needs, leasing appropriately, careful analyzing of costs/benefits, changing aesthetics to attract tenants and market the building are examples of the value added activities. Of the insurance companies interviewed, all are more interested in long term value due to current market conditions. They emphasize long term value instead short term value, by not providing a fee incentive salary for the asset managers. All asset managers have a base salary and are awarded a bonus based on overall performance of the portfolio.

## **THE BANK'S PERSPECTIVE**

### **Credentials**

The banking industry is very precise in its operations, with the federal regulations overseeing its transactions. As managers of depository accounts, officials interviewed must remain conservative in their outside investments in order to remain solvent. Customers depend on banks as a safe haven for their earnings and an instrument for borrowing money. The bank executives interviewed have found themselves as owners of real estate assets through non-performing loans. With the escalation of bad loans many banks have started separate real estate divisions to focus on these distressed assets. With the intricate processes of the banking industry, most executives have felt it advantageous to keep asset management in-house in order to formulate a coherent portfolio disposition strategy, and to hire personnel with real estate and banking backgrounds to run the department. The bank executives interviewed believe a real estate individual with some banking experience will help their understanding of the current strategies of the banks.

With the current disposition strategy, all respondents felt the need for an emphasis on disposition experience and an in-depth understanding of the marketplace. The individual must have the ability to focus on income, expenses and capital improvements in relation to the bottom line. Most banks look for individuals with an MBA or at minimum strong real estate and banking experience in lieu of the MBA. An MBA gives an individual a strong understanding of financial reporting and the most up to date methods of financial analysis. A person with just a real estate background acquires this same financial strength through working in the industry for many years. A seasoned real estate professional will have the background to accurately analyze any market and relate it back to a specific property.

### **Responsibilities**

The following list contains the responsibilities of the asset manager most emphasized by the banking respondents. They are listed in order of importance. The order of most important responsibilities corresponds directly with the current strategy of the banking institutions to dispose of all foreclosed properties.

<b>BANKING INSTITUTIONS ASSET MANAGER RESPONSIBILITIES</b>
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- |  |
|--|
| <ul style="list-style-type: none"><li>• Provide a business strategy for disposition of all non-performing loans</li><li>• Stabilize the properties</li><li>• Dispose at highest price - due diligence</li><li>• Maintain hands-on relationship with on-site mgt.</li><li>• Hire/fire property management and leasing agents</li><li>• Financial results/performance of property</li><li>• Identifying and meeting the highest performance level of a property</li><li>• Act as portfolio managers</li><li>• Track market trends and competition</li><li>• Formulate business plan and budget with property mgt.</li><li>• Set tenant mix</li><li>• Responsiveness to property management firm for</li><li>• Monitor property management - visit once a quarter</li></ul> |
|--|

In conclusion, the banking institutions need a well educated individual who understands the disposition needs of the institution. Ultimately this person must be able to provide accurate timing on the disposition to recover as much of the loss as possible. Due to the underlying goal of disposing of most of the portfolio, the asset managers are compensated with a straight salary plus a bonus that is based on the overall performance of the bank during the fiscal year.

## **CORPORATE PENSION FUNDS PERSPECTIVE**

### **Credentials**

Although all respondents are in an acquisition phase, they still are working through the distressed properties in their portfolio. To achieve their strategies they pursue individuals that have strong problem solving and portfolio

management skills. They will help work through the current portfolio and create a well diversified portfolio through acquisitions and dispositions. Ideally they will have an MBA and/or strong real estate background with an emphasis in financial analysis capabilities.

**Responsibilities**

The following is a list of responsibilities that are emphasized most by corporate pension funds:

<b>CORPORATE PENSION FUNDS ASSET MANAGEMENT RESPONSIBILITIES</b>
<ul style="list-style-type: none"><li>• Prepare a pro forma</li><li>• Manage a group of properties in as a portfolio</li><li>• Enhance revenues through excellent management</li><li>• Maximize cash flow</li><li>• Develop a capital budget plan</li><li>• Recommend acquisitions</li><li>• Asset restructuring</li><li>• Due diligence</li><li>• Give guidance in leasing/management process</li><li>• Cost/benefit analysis - efficient operating budget</li><li>• Hire/fire/monitor management company</li><li>• Assist in refinance/sale</li></ul>

Of the pension funds respondents, there was consensus that the 90's is a time for preserving value and not necessarily adding value. Preserving value requires a greater demand in the actual on-site and asset management. The emphasis in the responsibilities listed above relates to the desire to carefully acquire more assets

and manage all assets closely. Pension fund executives interviewed strive to add value through managing their portfolios, anticipating market trends, and capital improvements. Value is added through portfolio management by carefully diversifying the portfolio to balance out economic changes in different markets and product types. The respondents' reasoning is that by understanding the trends in each marketplace, portfolio and asset managers can better determine when to acquire and dispose of properties across the country and product type. In addition, all felt the asset manager must also understand the market trends in relation to the property in order to determine the timing on different capital improvements.

### **Summary**

The institutional owners depend on the asset managers to carry out the strategies and policies of the owner to the on-site management. All respondents utilize the role of asset manager to build a management team between the asset and property management. As mentioned in chapter two, all respondents follow the trend of the industry by seeking highly qualified professional. They are all looking for MBA's and/or a strong real estate background. The bank respondents add a banking background to the required credentials. All respondents want to create a quality management team and a culture of quality. In order to achieve this, they want the employees to understand the philosophies behind the principal business, because these philosophies are reflected on every investment decision.

Most responsibilities emphasized reflect the respondents' overall strategy for their real estate assets. All respondents are aiming to maximize value and stabilize income for their depositors. As mentioned previously, all insurance company executives interviewed are currently re-working their portfolios. All are



retaining certain properties and disposing of others. Four of the respondents are acquiring properties. To address all their strategies they emphasize the business plan and strategy for the property, the hiring and monitoring of property management and financial analysis for disposition and capital expenditure decisions. The banks are required to dispose of all assets, thus they emphasize responsibilities that prepare for disposition. They emphasize stabilizing the properties, creating and implementing the business plan, disposing the property at the highest price, the property management and leasing and a hands-on relationship with the property management to create a team between owner and on-site management. The pension funds have a greater stress on acquisition, so they emphasize creating pro formas, acting as portfolio manager, enhancing revenues through excellent management, and following market trends. There was a consensus among all respondents that one of the most important duties of asset managers are to keep abreast of the market conditions in areas where properties are located. Some of the respondents have market research personnel in-house to keep up to date on the different regions. In addition most of the organizations track the trends through real estate publications and market research in their own organization or through public agencies, such as Urban Land Institute.

### **OUTSOURCING TO THIRD PARTY MANAGEMENT COMPANIES**

The decision to outsource facets of the asset management process is faced by all institutional owners. All participating companies retained some sort of real estate department in-house. Exhibit two summarizes what the different institutional owners look for in third party management. In summary, they all are looking for a broad-based background with strong

local knowledge. They must be able to anticipate trends in the market. Another key component required by all types of institutions is the skills of the actual on-site personnel. Most participants put a lot of effort into hiring an excellent property management company, through interviewing, RFP's, and word of mouth.

### **What the Institutions Look for in Third Party Management**

#### **Insurance Companies**

For all companies interviewed, one of the most important responsibilities of the asset manager is to hire a competent third party management firm that will carry out the strategies set forth by the institution. Most respondents feel that an entrepreneurial property management company will be beneficial to the property. At times the top management of the institutions will be much more conservative about taking certain risks in trying to create value in a property. Entrepreneurial companies are more likely to take risks and push the owner to go beyond their ordinary parameters. Another measure of the management firms willingness to show risk and dedication is through the ownership of their own properties. Most respondents give property management firms a certain amount of autonomy to allow for creativity, but the asset managers have a lot of interaction with the property management firms in order to ensure quality service.

Exhibit two lists what insurance companies look for in third party management firms as compared to the other types of institutional owners surveyed. In order to accommodate their organizational needs and portfolio needs, one of the most important qualifications, emphasized by all participants, is the additional

services available, such as, development, construction, and leasing. This will eliminate the need to provide this level of expertise within the company. Some insurance companies do have individuals with an expertise in development, construction, law or architecture, but they are employed to oversee the processes performed by outside providers. In summary, the third party managers must have the local expertise to help close the "gap" between the owner and property. In the current market, they will be much more sophisticated and have the ability to provide detailed financial analysis.

### **Banks**

The banking institutions interviewed feel they are significantly different from the other institutional owners. All respondents have immediate disposition requirements and feel it is important to utilize outside management firms for their property management. As mentioned earlier, this eliminates the concern for placing employees in new positions upon disposition. In order to accommodate their need for disposition all respondents emphasize finding a company with specific strengths in the areas a particular property needs the most guidance. This will hopefully accelerate the disposition process. For ease on the asset managers, banks will try to utilize a service provider on more than one property, taking into consideration the company's presence in the local market and the needs of the property versus the management expertise. With their internal emphasis on asset management only, they seek service providers that have the ability to provide additional services such as development, leasing/brokerage, construction and any other services that may be needed in the management process of these distressed assets. This is true for other institutional executives interviewed. In general, the banks need companies that will perform all services, so the asset managers can

focus on the timing and logistics of the disposition process.

### **Corporate Pension Funds**

Referring back to exhibit two, the responsibilities emphasized by the pension funds interviewed relate back to their smaller, internal real estate department, that creates a greater dependency on the on-site property management. All of the pension funds interviewed outsource the property management services and other real estate services so they can better capture the expertise of the local market, and to keep their internal real estate departments concise. All respondents seek well seasoned real estate service providers that have a strong knowledge of the local market, due to their goal to maximize the earnings of their pension holders. Two of the executives look for management companies that have strong networking within the industry. They feel this enhances their outlook on individual properties by providing insight from competitors and other experts in the region. In consideration of the amount of autonomy a property management firm is given by the pension funds interviewed, they are expected to understand the responsibilities of the asset managers, in terms of financial analysis and having the ability to understand the property and market well enough to make recommendations on capital expenditures and disposition.

## THE CREDENTIALS OF THIRD PARTY MANAGEMENT

### Chapter 3 - Exhibit 2

	<b>Insurance Companies</b>	<b>Banks</b>	<b>Pension Funds</b>
<b>What they look for in third party management</b>	<ul style="list-style-type: none"> <li>• Capacity to provide addl. services</li> <li>• More sophisticated personnel - in relation to financial skills</li> <li>• Reputation/performance in local market</li> <li>• Service quality - tenant retention</li> <li>• What do they own - measures risk</li> <li>• Responsiveness</li> <li>• Market knowledge</li> <li>• Teamwork</li> <li>• Leasing and development expertise,</li> <li>• Enthusiasm</li> </ul>	<ul style="list-style-type: none"> <li>• More sophisticated personnel - in relation to financial skills</li> <li>• strengths in areas property is weak</li> <li>• Reputation/performance in local market</li> <li>• capacity to provide additional services</li> <li>• service quality</li> <li>• Responsiveness</li> <li>• Marketing</li> <li>• People skills</li> <li>• Concern about conflicts of interest</li> </ul>	<ul style="list-style-type: none"> <li>• Networking within industry</li> <li>• Understanding of natl. scope</li> <li>• Capacity to provide addl. services</li> <li>• Reputation/performance in local market</li> <li>• Understanding of property type</li> <li>• More sophisticated personnel - in relation to financial skills</li> <li>• Service quality</li> <li>• Decision making,</li> </ul>
<b>Type of contract</b>	<p>Most have a standard year contract that is 30 cancelable without cause. One participant has a 6-12 month initial period then month to month</p> <p>Paid on a % of revenue, sometimes with a floor or cap</p>	<p>Most have standard 1 yr. - 30 day cancellation without cause or 2 yr. 60 day cancellation without cause 30 days with cause. Have minimum fee - if good property will be a % of revenue</p>	<p>One year - 30 day cancellation, fee is a percent of revenue</p>

## **The Process of Choosing a Service Provider**

The preceding information addressed the specifics in what the different institutions are looking for in a third party management company. Each respondent felt strongly about how they go about hiring a third party company. All respondents emphasized that each property is unique, therefore they do not have a set procedure for developing a short list of companies to interview. It is the responsibility of the asset manager to decide what process to go through, in order to choose the best company for a particular property. With the market flooded with service providers, all respondents have been overwhelmed with companies contacting their asset managers. All asset managers interview a minimum of three to five different companies for each property. In most cases they choose the particular companies based upon their own knowledge of the area, and through companies that have contacted them previously. The asset manager is usually very familiar with an area and will know what management companies are competitive.

### **Solicitation Process**

The additional companies chosen will generally include a larger national firm used for other projects and smaller local firms that boast an excellent reputation. In the case where the asset manager is unfamiliar with a region, they send out an RFP to seek out the local talent. When they send out RFP's they look to see how familiar a company is with the project and how they think they can improve the performance of that property. They look at any innovative ideas a company has and how in-line they are with what the owner's strategy is for the overall portfolio and the individual project. Of the RFP's reviewed during the interview process, the following were the most

significant questions:

1. Company information:
  - years in business
  - name of principles/professional affiliations
  - breakdown of staff
2. Properties managed by the organization:
  - property address/type
  - gross building area
  - occupancy
3. Experience with "start up" of a property.
4. Who would be assigned to the property - professional background.
5. What institutional owners have you worked with in the past.
6. Information technology
7. Details about knowledge of immediate market area
8. Specific operational aspects of property in questions:
  - recommendations on capital improvements
  - What would be contracted out

#### Making it on the Short List

Several of the large insurance companies and the banks are seeking to downsize the number of different management companies they utilize. In these cases the asset managers will look at the performance of a company on other projects they are managing within the portfolio and decide whether, or not, to interview them for a new project. In terms of making it on the short list, management companies need to make their abilities known to the asset manager and be able to sell their services in this competitive market. As mentioned previously, all executives interviewed mentioned, to varying

degrees, the importance of the actual personnel that will be on-site. The asset managers will be a part of the selection process of on-site personnel. Some also mentioned the importance of looking at the structure of the entire management company in terms of policies and quality service programs. Often times asset managers will depend on local brokers to share their knowledge and experiences with different management companies. Three of the companies interviewed have a company wide grading practice to utilize during the interview process. They grade each company on specific criteria they are looking for in management for a particular property. At the end of the interviews, they show the companies why they did or did not get the management contract. None of the executives interviewed mentioned favoritism towards companies that currently have an established relationship. If a company does have an established relationship and has performed well, they will have an upper hand in the interviewing process, but a minimum of three companies are always interviewed per property. It is a very subjective process.

### **Summary**

All of these companies outsource certain traditional asset management duties, such as financial analysis, lease analysis, tenant analysis, develop and define leasing parameters, make recommendations about sale, implement and monitor strategic plan and property budget, and keep abreast of market trends and competition. Most respondents felt the property manager's ability to understand and implement these responsibilities, helps strengthen the management of the property an overall portfolio. Traditionally, property management did not incorporate these responsibilities thus their decision



making abilities were not as strong as they need to be in today's market. The respondents feel there is more of a dependency on the property management by the asset manager to help make important capital improvement decisions and leasing decisions, and to understand the effect different expenditures have on the bottom line. This increased knowledge and understanding of the entire management process assists in creating quality service in management. It improves the responsiveness and communication among the entire management team, which reflects on better service to the tenants. Most expect property managers to have a stronger financial background and be able to make financial decisions based on the overall institution strategy rather than simply looking at the individual property. Other participants in the survey with smaller portfolios and the banking institutions generally have more interaction with the properties.

The insurance company respondents look for more entrepreneurial property management companies to create innovative ideas. As a large corporation there is limited entrepreneurial creativity, because it is such a structured environment. An entrepreneurial company brings creativity and strong local knowledge. The bank respondents seek companies that are strong in the areas where a particular property needs the most attention, in order to expedite the disposition process. The pension funds are seeking companies with an understanding of the national scope in order to accommodate their acquisition strategy. They feel a company with strong networking skills will have a better understanding of the market and competition and would have the ability to suggest acquisitions.

Exhibit two lists the standard types of contracts used between owner and third party manager. In general, all institutions use a one year contract with 30 days cancellation with or without cause. The fees are usually a percentage of revenue, some have a floor or cap depending on performance, to eliminate a fee incentive. Some insurance companies operate on a guaranteed six to twelve month initial contract rolling over to a monthly contract. The banking institutions differ in the length of the contract by sometimes using a two year contract with 60 day cancellation without cause, 30 days with cause. Across the board, each institution feels the importance of being able to cancel the contract on short notice. This is primarily for ease in disposition of the property, but also relates to their dedication to increasing the value of their portfolio. If a management company is not performing the owners expectations, they will be replaced.

## **IMPORTANT RESPONSIBILITIES OF THIRD PARTY MANAGEMENT**

### **Introduction**

Exhibit three is a summary of responsibilities emphasized by each type of institutional owner. It also shows the ways each type of institution measures the success of a particular management firm.

## **INSURANCE COMPANIES**

### **Responsibilities**

Insurance company executives interviewed emphasized the ability of a property management firm to meet the corporate expectations and parameters placed on the property. Most respondents expect the property managers to be

creative and recommend capital expenditures and other creative ways to enhance the property, but all ideas out of the realm of the annual budget and business plan must be presented to the insurance company for approval. Leasing is also a significant responsibility of the property manager. In most cases the asset manager works directly with the property management team to set up an appropriate tenant mix and set of parameters that must be followed. All of the respondents give the property management team full control of pursuing perspective tenants and bringing them to final lease negotiations. The asset manager will administer the final lease negotiations and obtain the final signature. With such a wide array of assets the asset manager depends on the property management to track local trends and anticipate the moves of competitors in the region.

### **Measure Success**

Insurance companies have several ways of measuring the success of their third party management team. The two most important measures that are seen across the board are: meeting budget and strategic goals and tenant retention. Most insurance company executives also look for the managing agent's ability to challenge the ownership on ways to enhance the return from the property. All respondents use the physical appearance of the property as a way to see how detail oriented the company is to the overall aesthetics of the property. A final measurement most insurance company respondents use is their ability to strengthen the lines of communication between owner and manager, manager and tenant, and tenant and owner. There should be regular interaction between these parties. The asset manager is expected to be available to the tenants when visiting the property in order to address any problems or concerns that the property management is not resolving.

## **BANKS**

### **Responsibilities**

All banking institution respondents depend on the property management company to carefully follow the budget and strategies provided by the bank. Due to their disposition needs, all reporting must be accurate and produced on a regular basis. They all give the property manager full autonomy to enter into subcontracts as long as they are month to month in anticipation of disposition. All banking institutions interviewed are bottom line oriented and expect the on-site management to remain within budget and try to decrease expenses. Most require property managers to report to the asset managers weekly to keep the owner abreast of market trends and financial conditions relating to the property.

### **Measure Success**

Of the banks interviewed most felt the primary way to measure the success of the management firm is through their overall performance against the budget. Their leasing abilities and success of their management team are also ways to judge the company's ability to efficiently manage the property. One final way that a few use to measure the success, is through their coordination of the relationships between owner and management, owner and tenant and management and tenant, created during this endeavor. They believe open lines of communication and strong relationships between all parties involved are important to the success of their investment.

## **PENSION FUNDS**

### **Responsibilities**

All pension fund sponsors interviewed look to the property management to provide strategic decisions on the management of the property. They are expected to understand value in the asset, exit strategies, lease rollovers and the overall budget process. Of the three types of institutional organizations interviewed, the pension funds have been involved in real estate for the shortest amount of time and will often give the property management more autonomy than banks or insurance companies. In the case of the three interviewed, their asset managers monitor the property management, but they look for the ability of the property management to practice a reasonable amount of autonomy. They give the property management full responsibility for leasing and operating duties to ease the demands on the asset manager, so the asset manager can focus on the performance of the overall portfolio. This also allows the asset manager to focus on the creation of value in the asset and portfolio as a whole. With the acquisition strategy that the three respondents are following, they believe it is beneficial to relieve the asset managers of some hands-on involvement with each property. They will monitor and enforce corporate strategies and policies, but depend on the property managers to use their experience and expertise to make appropriate decisions. They would rather utilize the asset management skills to improve the overall portfolio. The asset managers actively work with the portfolio managers on acquisition and disposition recommendations, because they tend to be more actively involved with the different markets. Of the three pension funds only two retained portfolio managers in-house the other depended on the asset manager to perform both responsibilities.

### **Measure Success**

The pension funds interviewed measure the success of the management company through their leasing efforts, tenant retention, and ability to operate efficiently. They all expect a management company to be in tune to ways of decreasing overall operating expenses and looking to run the property as leanly as possible. All respondents are willing to invest additional capital to lower overall expenses in the future. The bottom line is very important to the owner. They focus on tenant retention to improve the bottom line by minimizing brokerage fees, tenant improvement money and loss of rent.

### **Summary**

In all three cases the institutional owners emphasize an increase of financial responsibilities from the property management. The asset manager handles the pro forma and strategic planning of the property, but they depend on the property manager to have these skills and understand the implications that capital expenditures and other operating expenses have on the overall return of the property. In addition, they expect the property management company to practice service quality and create a tenant retention program, which is one way the owner can measure the service quality of the property management firm. Tenant relations is very important to the well being of an asset and the property manager must coordinate the relationship between the management firm and owner. Most importantly, they must be responsive to both owner and tenant.

Each type of institutional owner emphasized responsibilities that matched their own need to interact with the on-site management and the

strategy for the property. The insurance companies and pension funds interviewed both depend on the property management more for financial analysis and other traditional asset management activities. This is due to their strategy to retain properties in order to regain the lost value. They both monitor the property management closely and expect their asset managers to set parameters that match the company goals, but they give the property management a lot of responsibility. The banking institutions interviewed expected additional skills from their property management, but retained strong control of all their assets due to the disposition process. Their asset managers remain in constant contact with the property managers in order to time the disposition appropriately.

With today's challenging real estate market, there are new demands on the management of properties. Until the past five to ten years, the asset management role had not really existed. Now real estate departments are forced to expand due to the changes in the economy and the challenges of real estate as an investment. In the past there was greater demand for development and less of a need for asset and property management due to lack of significant competition. Chapter two presented a chart showing the traditional property management responsibilities compared to asset management responsibilities. With the demanding market, property managers are expected to have more of an understanding of the overall management of the property. They must understand asset management responsibilities and act as if they are owners. In the past they simply produced monthly operating reports and oversaw the property.

## THE RESPONSIBILITIES OF THIRD PARTY MANAGEMENT

### Chapter 3 - Exhibit 3

	<b>Insurance Companies</b>	<b>Banks</b>	<b>Pension Funds</b>
<b>Important Responsibilities</b>	<ul style="list-style-type: none"> <li>• Cost benefit analysis</li> <li>• Understand/ implement strategies</li> <li>• Financial analysis</li> <li>• Leasing</li> <li>• Proactive</li> <li>• Hire subcontractors</li> <li>• Accuracy/timeliness</li> <li>• Market knowledge</li> <li>• Variance reports</li> <li>• Recommend capital improvements</li> <li>• Tenant retention/tenant relations</li> <li>• Reporting</li> <li>• Tenant surveys.</li> </ul>	<ul style="list-style-type: none"> <li>• Implement strategies of bank</li> <li>• Subcontract</li> <li>• Accounting and reporting</li> <li>• Follow budget</li> <li>• Monthly variances</li> <li>• Tenant surveys</li> <li>• Tenant retention</li> <li>• Market trends</li> <li>• Report to asset manager weekly</li> </ul>	<ul style="list-style-type: none"> <li>• Leasing</li> <li>• Strategic decisions:                             <ul style="list-style-type: none"> <li>• understand value</li> <li>• exit strategies</li> <li>• lease rollovers</li> <li>• budget</li> </ul> </li> <li>• Follow parameters set by organization</li> <li>• Tenant relations/tenant retention</li> <li>• Advertising/marketing</li> </ul>
<b>Measure Success</b>	<ul style="list-style-type: none"> <li>• Meeting budget and strategic goals</li> <li>• Tenant relations/retention</li> <li>• Physical appearance of property</li> <li>• Challenge ownership</li> <li>• Leasing</li> <li>• Communication</li> <li>• Reporting accuracy</li> <li>• Personnel</li> </ul>	<ul style="list-style-type: none"> <li>• Meeting budget and strategic goals</li> <li>• Tenant relations/retention</li> <li>• Leasing</li> <li>• Communication</li> <li>• Reporting accuracy</li> <li>• Bottom line- NOI</li> </ul>	<ul style="list-style-type: none"> <li>• Leasing</li> <li>• Tenant relations/retention</li> <li>• Meeting budget and strategic goals</li> <li>• Reporting accuracy</li> </ul>



## **SERVICE QUALITY**

The economic state of the real estate industry has triggered a highly competitive market. Markets are overbuilt, resulting in high vacancies, and rents have to remain competitive to attract tenants. This combined with the reversion of properties back to institutional lenders, who are now unwilling owners, has resulted in a need for higher quality management. There are many more management companies in the industry that have been created out of the lack of development and brokerage opportunities. This adds to the pressure for unique service from outside providers.

All participants interviewed agreed that service quality is unquestionably one of the most important aspects of managing a property. Several of the participants are currently undergoing measures to create a service quality training program for their internal staff, and the service providers that they hire. Of the companies contacted the following items were listed as important to service quality:

<b>DEFINING SERVICE QUALITY</b>
Speed and self confidence in decision making
Anticipation of problems
Responsiveness to owner and tenant
Quality reporting
Appropriate staffing
Teamwork
Quality staffing
Degree to which they have a good internal reporting system

These findings are consistent with the research presented in chapter two. The participating companies find that service quality enhances the value of their

assets. They find that third party management firms with a dedication to service quality have better satisfied employees who are more dedicated to their property management responsibilities. Many of the management firms interviewed carry on their emphasis on service quality to the level of subcontractors that they hire for additional services.

All respondents believe tenant retention is one of the major components of service quality. All companies that participated in the survey expected the management company to conduct a tenant satisfaction survey once a year. This survey was one tool used to measure the satisfaction level of the management staff. The institutions also expected their asset managers to conduct their own personal surveys. During every visit they were expected to visit with tenants to keep up to date on the performance of the management staff.

Tenant retention is dependent on service quality. As mentioned in chapter two, tenants are willing to renew a lease if they feel they are treated as a valuable asset to a building. Retaining tenants is very important in this market. First of all, the high vacancy rate has made it a tenants' market. Tenants are able to negotiate favorable terms on space due to the availability of space. Secondly, by retaining a tenant, you are not only saving money on lost rent, but you are avoiding brokerage fees and significant tenant improvements.

Several companies interviewed have formulated a tenant retention program. Of those companies that have yet to establish a program, all were in the process of formulating one. Some of the companies have set up copy rooms on each floor, as a customer service for all tenants. Other programs include a building wide phone system that lowers the rate for each individual tenant. Additional services, such as

shoe shine, hair salon and travel agent are added for the convenience of the tenants. Day care units and car pool programs are other ways of providing an incentive to the tenants to remain in a building. These programs are simply amenities to the normal services. Tenant retention commences at the point the initial lease is signed. During the negotiation process there is a tremendous amount of interaction between owner and tenant. That relationship needs to continue throughout the term of the lease. The on-site management needs to be available and visible to the tenants on a daily basis. In addition, the on-site management needs to anticipate service that would be of value to the tenants.

Service quality is a fairly new phenomena to the real estate industry. All institutional owners interviewed felt it is an important part of the success in asset management and in property management performance on a property. None of the institutions interviewed currently have a service quality program in place within their own organization. Most respondents stated that they were in the process of formulating an internal program that will enhance the program brought to a property by a third party manager. Across the industry, the value of service quality is becoming better understood and will receive increased emphasis by all companies interviewed for this thesis.

This chapter has presented the pertinent data obtained via interviews of various institutional owners. In summary, the institutions have set up real estate departments to administer the acquisitions, dispositions, and on-site management of their properties. These functions are performed by an in-house asset manager. Each type of institution has unique expectations of their asset managers and third party managers, with some consistencies across the board. In general all institutions are seeking to create value in their distressed real estate. They want to

recover their losses and increase their profits. They will go through whatever measures are needed to achieve these goals. They have realized the importance of watching their real estate portfolios more carefully, trying to anticipate potential problems. The internal real estate department provides a liaison between the property management, tenant and owner. Through this process the institutional owner has given up the traditional passive role as real estate "investor" or "lender". They now have to play a proactive role in the ownership and management of the properties.

## **CHAPTER 4 -INSTITUTIONAL MANAGEMENT IN PRACTICE**

Based upon the literature reviewed and the interviews conducted, this thesis has described various ways the ownership and management of real estate assets have changed in reaction to the contraction of the real estate industry. External and internal pressures have led many in the industry to conclude that there is a need for greater emphasis on service quality in the management and ownership of properties. A major external issue is the oversupply of properties in the office market and the resulting increased competition for tenants. A focus on excellence in management is one potent weapon in the struggle to attract and retain quality tenants. Another external issue is the weak state of the economy. That, coupled with the market oversupply, has led to a decrease in property values while operating expenses have continued to grow. These conditions require the most sophisticated financial analysis skills on the part of the property managers and asset managers, to achieve positive cash flows. An important result of these economic and market pressures is an increase in the number of business failures among developer/owners and the reversion of some real estate assets back to institutional investors and lenders who may not always be staffed to handle management responsibilities internally.

Other factors promoting increased attention to service quality relate to the institutional owners' investment preferences, and their traditional investor's-lender's attitude towards their real estate portfolio. Institutions commonly avoid exposing their funds to a high level of risk, but they have deep pockets and can invest additional funds, as necessary, in a property and take a long-term perspective when, warranted And they need to achieve a good return from their

investment to meet the return requirements of their clients. Each type of institutional owner has different organizational requirements, that affect the decision of whether to staff up internally or outsource asset and property management.

### **Outsourcing vs. In-house Management**

Throughout this research, arguments for staffing up were as common as arguments for outsourcing all management responsibilities. Institutions are passive investors-lenders of real estate since their principal businesses are in other areas but the number of properties reverting back to them has been so great that they must work actively to revitalize these investments. In some cases the value lost in real estate is so great the very solvency of the institutions has been threatened, and they have been forced to retain some direct control of the real estate assets.

#### **In-house Asset Management**

Establishing asset management internally provides the institutional owner with more control over its assets. For example, internal asset managers are familiar with corporate policies and procedures, and can provide consistency in the management and reporting process for each property. An internal real estate department will better understand the portfolio management implications of the institution's principal business, and allows appropriate flexibility in their portfolio strategies, outsourcing less important responsibilities to reduce overhead. This is cost effective. One company interviewed is currently developing a property management division in order to retain all management fees. This strategy would improve the bottom line as well as provide more control of the asset though the owner must have enough assets to support the overhead costs.

### Outsourcing Property Management

An advantage of outsourcing the property management function is that institutions do not have to worry about relocating personnel upon disposition of the asset. Another advantage is that management company employees are used to working together as a team, a factor which provides high quality work. Local knowledge also promotes quality, which is another reason why institutional owners may decide to outsource the property management duties. It is very difficult to develop local knowledge internally when properties in a portfolio are scattered throughout the country. Another factor which enhances performance is the tremendous amount of competition among property management firms for contracts creates great pressure on third party managers to perform to the institutional owner's expectations. At the same time, the institutions gain flexibility in being able to change property management companies to achieve the best performance.

When we looked at the benefits and costs to outsourcing asset and property management in chapter two and compared this to data presented from the interviews in chapter three, we found that institutional owners have retained the most important decision making management responsibilities internally. The internal responsibilities vary by institution type and their strategies, as mentioned in chapter three. They have outsourced other functions to take advantage of lower overhead costs and greater local knowledge, and quality service at the property level. For example, banking institutions retain only asset managers internally due to their disposition requirements. It only makes sense to professionals to handle the disposition and outsource the rest since almost all properties will be sold.

## **DEVELOPING A CULTURE OF QUALITY**

The development of a culture of quality involves drawing up guidelines within a company to provide consistent management of its properties. A culture of quality includes clarifying the roles and responsibilities of property and asset management, as they relate to strategy, credentials of staff, and lines of communication.

### **Shifting Roles and Responsibilities of Asset and Property Management**

At the beginning of chapter two, the traditional roles of property and asset management were presented. The property management role in the past was simply the operational responsibilities of on-site management. The traditional asset manager handled financial analysis, leasing strategies, and property management selection. As the real estate climate has become more complex and properties have reverted back to investors, these roles have been forced to change.

#### **Asset Managers**

Overall, new ownership and depressed market conditions have placed more demanding expectations on asset management, which, in turn, has resulted in greater demands on the property management. Asset managers now have a combined portfolio and asset manager role. This has led to higher expectations by the institutional owners as to the financial capabilities of asset and property management. In general, the asset manager is expected to have more in-depth financial and market knowledge in order to anticipate market trends and better determine when to dispose of, or acquire, a property. Asset managers need to understand the institution's management information systems and create and monitor the best strategies for the owner. They also need to pass along the



institution's expectations to the on-site management and maintain a quality environment.

### Property Managers

The property management is expected to understand and implement the traditional asset management responsibilities. Property managers must work directly with the asset management to create a business plan and strategy for the property. The property managers are expected to increase value in the property by maximizing income and controlling operating expenses. They are also involved in the redevelopment decision process and are expected to make recommendations on redevelopment, disposition, tenant improvements, capital improvements, and other pertinent value creation decisions in relation to the property. With the increased competition in the marketplace, property managers need to keep abreast of the competition and focus on the leasing of vacant space while maximizing tenant retention. Among institutional owners, insurance companies and pension funds give the property management more autonomy than banks. The banking institutions retain tight control due to the degree of proprietary information involved in these transactions.

### **Institutional Owners**

In all cases, the institutional owners are looking to maximize the value of their real estate. In order to achieve this goal, they need to seek individuals and companies that focus on service quality and match the strengths of these people to their portfolio strategy.

### Insurance Companies

The insurance companies are trying to revitalize various types of properties

acquired through default. They are stabilizing their portfolios through disposition of properties that cannot perform up to the standards of the portfolio. Typically they set a hurdle rate that must be met to reinvest or maintain a property consider the current and future market conditions and potential capital improvements that may be needed. With these strategies in mind, the insurance companies emphasize the creation of a business plan and strategy for each property and hire and monitor a property management firm to ensure their strategies are implemented.

Property managers need stronger financial skills to monitor the income of the property, and to advise on disposition and/or acquisition. In order to maximize value they must carefully consider the timing of any major expenditures. They also must emphasize service quality to retain tenants and assist with leasing strategies set by the internal asset manager. The quality must also carry through on written reports submitted to the owner. The internal asset managers utilize these reports to monitor the property and adjust ownership strategies when necessary.

### Banks

The banks must dispose of all their real estate assets, as mandated by the federal government. So for banks all management strategies are aimed at disposition. A bank's asset manager must set up a business plan and strategy for a property to expedite the disposition of it at the best possible price. Asset managers need to have experience in disposition, in order best to time the sale of the property. The bottom line performance of the property, local market penetration, and market trends are important determinants in timing the disposition. Therefore, the property management staff must have a strong knowledge of the local market. The property management needs to maintain quality accounting and financial

reporting to help with the due diligence process. There is also a strong emphasis on limiting budget variances. Operating costs need to be controlled to help create value in the property. The quality of the bottom line cash flow is a very important factor in a banks' disposition strategy.

### Pension Funds

Typically large pension funds are actively acquiring properties to diversify their real estate portfolios. Their strategies are similar to many insurance companies, maintaining, improving, and acquiring real estate assets. Their asset managers must create pro formas for potential and existing properties in the portfolio. The pro forma is emphasized more by pension funds than insurance companies, due to the larger number of acquisitions taking place. The asset manager recommends acquisitions and handles the due diligence prior to acquisition. With asset management focused on acquisition, there is a greater dependence on the property management than within insurance companies and banks. The pension funds expect property management function to focus on strategic decisions such as understanding the value of the property, exit strategies, lease rollovers, and the budget. These are important in creating long term value in the property.

### **Credentials for Internal Asset Management**

We have seen the importance of creating a culture of quality. Part of this culture is related directly to the strength of the individual employees. The culture of quality begins with internal personnel. With the increased demands of the institutional owners, there is a greater emphasis on the credentials of the internal employees. Through the literature research and interview process it was found that institutional owners seek individuals with strong financial analysis and

applications background. They look for professionals that hold a MBA, or equivalent degree, with a practical performance ability. This educational background provides the individual with the rigor of higher education and a stronger financial background than past asset managers. Graduate programs in business provide individuals with the practical skills such as finance, marketing, management, accounting, economics, and training needed to address the various needs of the real estate industry. These skills allow them better to understand the responsibilities of other professionals in the real estate field. The institutions need these skills to directly handle the newly acquired real estate assets.

Based on the interviews and research conducted, the institutional owners look for individuals with professional designations such as CPM, (Certified Property Manager) and CSM, (Certified Shopping Center Manager), in addition to an advanced degree. Professional designations represent the advanced level of expertise and experience an individual has in his/her particular field. By requiring proper credentials, institutional owners will gain the reputation of providing highly trained professionals to monitor their properties and facilitate the leasing and tenant retention process.

### **Lines of Communication**

Communication is essential in the management of any business. The better mechanics of communication that are in place, the better the quality of management. Institutions are often located far from their properties, good asset management will shorten the lines of communication by working directly with the third party property managers. Across all institutions, the asset managers visit the property weekly or monthly, depending on the needs. A minimum number of visits is once a quarter. There is always contact with the on-site management on a

daily basis by phone or in person. This relationship creates a critical link in maintaining the specific strategies and guidelines set by the ownership. Ease in communication provides consistency in all aspects of the management of each property. Therefore, written reports and accounting/financial reports must be based upon the systems of the parent institution for ease in understanding the information being generated and to promote consistency among the different service providers utilized by a particular owner. The asset manager provides the property manager with the guidelines for the reports and provides any needed assistance to ensure consistency with the owner's standards and policies. The importance of the lines of communication between the institutional owner and property management reflect the fiduciary responsibilities the institutions have to their beneficiaries.

## **MEASURING QUALITY**

To maintain quality service it is important for the institutional owners to measure the performance of asset managers and property managers. Employers are beginning to experiment with measurement programs that evaluate employees' performance. Several of the insurance companies have extensive evaluation procedures and they have found that these tools have improved the performance of their employees.

### **Internal Asset Management**

#### **Compensation of Asset Managers**

Many properties in an institution's portfolio are distressed. This makes it difficult to compensate internal asset managers on bottom line property performance. Based on the information gathered during the interviews, in order to maintain quality internal asset management, the institutional owners must pay a

straight salary instead of a salary based on performance of the assets. One way to create a monetary incentive is through bonuses based upon the performance of the portfolio. This will offer incentives to the asset managers to work as a team to bring value back to the total portfolio.

### Measuring Performance of Asset Managers

All institutional owners find it difficult to base the entire performance measure on increased cash flow since some of the properties will be poorly performing properties. Performance is often measured in relation to the asset manager's ability to hire and maintain quality third party property management firms, and the ability of the asset managers and property managers to work together to meet the goals and expectations of the owner. It is important not only to measure the performance of the asset managers in relation to the property, but also to measure their ability to work successfully with the property management. Based on several interviews, institutions believe smooth interaction between the two parties was directly reflected in improved bottom line performance of the property.

### **Outside Service Providers**

#### Contract with the Service Provider

Historically, third party property management firms were paid a percentage of revenue from the property and a certain percentage of new leases. With the changing real estate climate, institutional owners need to change their compensation structure. Many properties are not producing positive cash flow. In these cases, to maintain quality management, the institutional owners need to pay the property management company a flat fee, or percentage of revenue with a minimum fee. Based on several interviews, institutional owners are often willing

to pay above market rates for excellent management, even though service provider's compensation rates are declining due to the increased competition. And there are still many cases where the fee is based upon a percentage of revenue, with a floor and ceiling on the amount received by the management company. In order to maintain quality leasing, the institutional owners interviewed incorporate leasing fees through the term of the lease rather than a straight percentage off the value of the lease. This will motivate the leasing personnel to obtain solvent tenants that will follow all terms of the lease and remain on-site for the duration of the lease.

Institutional owners look for similar credentials for third party personnel as for asset managers mentioned earlier in this chapter. In addition to the educational and professional designation preferences, the institutional owners look for strong people skills, enthusiasm, a reputation for service quality, and local knowledge. In some cases, the institutional owners interviewed mentioned that their asset managers often get involved in selecting the on-site personnel. It is important to create a team and the on-site personnel must be able to work well with the asset manager.

### **Measuring the Performance of the Service Provider**

In order to ensure that the goal of quality management is being met, the institutional owners must measure the performance of the service provider on a regular basis. The property management team has the most interaction with the tenants and must be available to handle all problems immediately. Based on the research, the most effective way for owners to monitor the performance of property management is through their responsiveness to tenant needs. The property management's responsiveness relates directly to tenant retention. One

way to find out the weaknesses of the property manager is through researching why a tenant relocated. Tenant surveys are administered by the property manager annually as another measure of the management's performance. The institutions will review these surveys in order to analyze the level of tenant satisfaction. Performance of the property management is also measured on a monthly basis through their ability to stay within the budget.

### **BUILDING A TEAM**

Based upon all of the interviews conducted, a quality team is important to the overall performance of the property. Each management level must enlist the same dedication to service quality and work as a team to meet the goals and strategies of the owner.

#### **Selection Criteria for Third Party Management**

When selecting a property management firm, the institutions interviewed look for qualities that suit the needs of their organization. Across the board, two important qualities are the additional services available and the firm's dedication to service quality. It is the responsibility of the asset manager to locate the best property manager for a property. The asset managers look at each property individually, and usually interview a minimum of three firms. The firms are chosen based upon their local knowledge and ability to address the needs of the property. Several of the large insurance companies and banks are trying to limit the number of different third party management firms they use. Therefore, they look at firms that are currently managing other properties within their portfolio, along with new local firms. For a new firm to get on the short list for a management contract they must have an excellent reputation and strong local expertise. Pension funds and insurance companies with smaller real estate



portfolios tend to emphasize local expertise and excellent reputation in the market. They are focusing more on maintaining their real estate and are flexible and willing to hire a small, local entrepreneurial company.

### **Integration of Asset and Property Management Roles**

The ability of the asset and property managers to work together as a team is important to the success of the property. The integration of the two roles forces each to fully understand the responsibilities of the other. The asset manager passes down a certain degree of dedication to service quality to the property manager, to carry out in his day-to-day management. This quality is expected to be exemplified in all aspects of on-site management, even in subcontracted services. Consistency is an important part of service quality, therefore all personnel connected with a property must practice the same degree of service quality. The property manager will use the same performance measurement techniques for the subcontracted services as the asset manager uses for him.

### **CONCLUSIONS**

The oversupply of real estate has created the need for the new institutional owners of real estate to create a culture of quality in the management of their real estate portfolio to regain value in their assets. This culture of quality is best achieved through retaining the most important aspects of the management internally in order to maintain control over the assets while outsourcing the balance, where it is important to have strong local expertise. All the companies interviewed are in the process of creating their own internal service quality and tenant retention program.

All institutional owners interviewed have a strong commitment to service quality. This commitment is seen through all aspects of the management of their real estate assets. The trend in the service quality sector will continue in the future. To create a culture of quality owners will continue to adjust the size of the real estate department to meet the needs of the portfolio. Many institutions interviewed are in the process of creating an internal service quality program that will include a rigid tenant retention program. In order to survive in this competitive market the institutional owners must provide a quality product from ownership down to the on-site management.

Part of this dedication to service quality is carried into the third party management firms they hire. Each institution has a very diverse portfolio and each property has unique needs. The internal asset manager will continue to focus on hiring a service provider that meets the needs of the property. For instance, if a property must be redeveloped, the asset manager would look for a service provider that has a strong development expertise. In addition, they will focus on companies and individuals that can work well with the institutional strategies and policies.

In addition to matching the third party management with the institution, each institution interviewed will continue to seek out internal personnel with a strong understanding of the policies of the institution. There is a growing trend to include well educated and experienced personnel internally. They will create a core expertise that will be able to successfully pass along both institutional strategies and a dedication to service quality.

This thesis has shown the importance for institutional owners of developing retain personnel with real estate expertise internally to make up for their own lack

of practical experience in real estate. The future will see tight controls on real estate assets. Institutional owners are involved in real estate for the long term value and continuous cash flow. With this in mind they need to retain tight control to ensure these requirements are being met.

The service quality framework presented in this thesis shows the advantages of a more dynamic process of asset management versus more static measures of bench marking. This is primarily due to the uniqueness of real estate properties and the significance of the asset and property management role in today's market, and in relation to the specific needs of the institutions.

Hopefully future players in the market will learn from the experience of the 80's and prove one expert wrong, who believes, "If there is a need for 1 million square feet of office space in a particular market, we are aware that 2 million square feet will be built, because everyone else thinks they have a better mousetrap or more bells and whistles."<sup>55</sup> The experience of the 80's and 90's to date has brought a new perspective to real estate development and investment. Investors are more prudent in their investments, developers are either disappearing or expanding their services into management and other areas of expertise. The institutional owners are more sophisticated and better able to handle their real estate assets. This thesis opens the door to future research in relation to the different institutional owners and their strategies for real estate asset management. Several institutions have experimented with developing their property management division to retain all fees internally. The success or failure of these attempts are means for further research.

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<sup>55</sup>Powers, Marie, "Pension Funds Divided on Wisdom of Investing in Real Estate," *National Real Estate Investor*, September 1992, p. 38.

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