

“Management Value Added” is important – but fundamentals still dominate

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- *The assessment of management is a crucial element of investment analysis*
 - *The mechanics of how to measure management performance, however, is sometimes unclear – there needs to be delineation in terms of what is under management control, and what may not be*
 - *Even though management has influence on REIT portfolio value creation, there are factors not under their control that substantially influence shareholder returns – property fundamentals still dominate*
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The assessment of management is often referred to as a crucial element of investment analysis. If I had a Dollar for every time someone touted the importance of “management ability” or “management quality,” I’d undoubtedly have already retired. While it is proven that management can create and/or destroy shareholder value over time, the mechanics of how to measure this, however, can often be unclear.

Investors often look to total shareholder returns and numerous other quantitative and qualitative measures in assessing management. The weakness in many such methods, regrettably, is that there is no distinction in terms of what is under management control, and what is not.

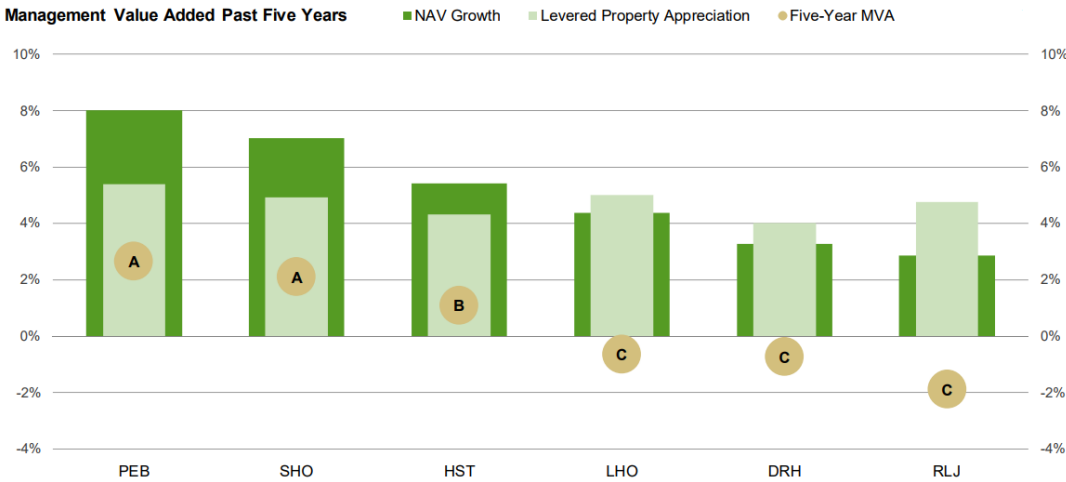
According to Green Street Advisors (GSA), Pan-European property experts, differences in location and property sub-type within a certain property sector have had a substantial impact on the appreciation of portfolios of seemingly similar REITs. In line with this, GSA states that the most significant driver of return differentials over the last few years has been the composition and location of property portfolios.

Therefore, as per GSA, the way to assess management value added (MVA) is by netting off levered property price appreciation when measuring portfolio NAV growth. Simply put, MAV = NAV growth minus leveraged growth in portfolio value. MVA reveals how much of the total gains have accrued as an actual result of management decision-making but does not credit or penalise management for variables that they could not control or influence.

The key drivers of REIT NAV growth include; a) property portfolio performance (dependent on sector, quality and location), b) balance sheet management (including financial risk management), and c) capital allocation acumen (such as embarking on growth initiatives, using stock as currency, when share prices are trading at significant premiums to NAV). MVA includes the last two while excluding the first.

The following graphic shows MVA within the United States hotel REIT sector. Where MVA has been highest, the REIT receives an A rating. This shows how management teams have added to, or detracted from, investment returns.

Hotel REITs

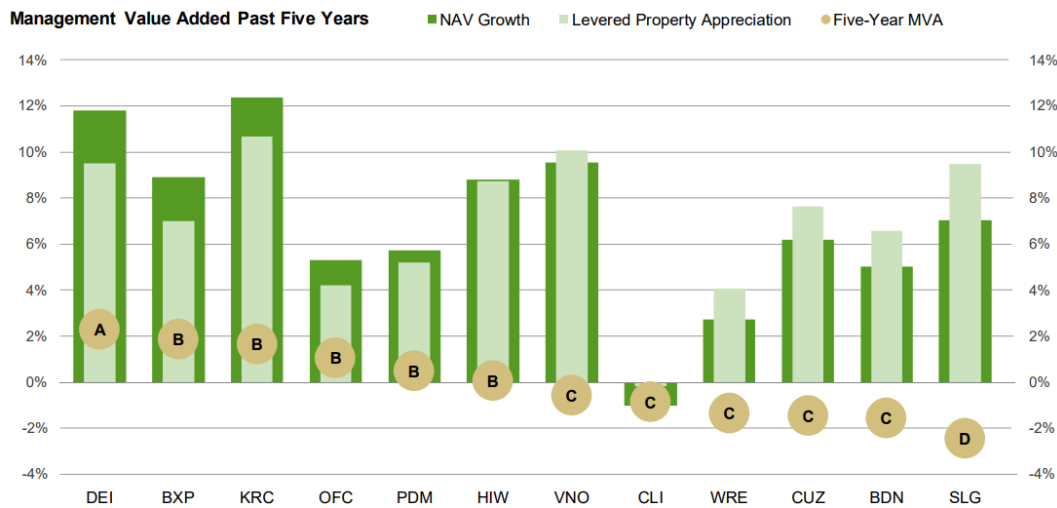


Source: Green Street Advisors

Pebblebrook Hotel Trust (PEB) scores highest in its sector with a MVA of ~3% while RLJ Lodging Trust (RLJ) is at ~-2%, related to the ill-advised acquisition of Felcor.

Below we see how office REIT management teams have fared in terms of MVA. Douglas Emmett (DEI) has been the superior office REIT as per this metric indicating that a focused growth strategy, even if measured, can create value. SL Green's (SLG) bottom rank is largely due to allocating to large developments that have generated relatively weak returns.

Office REITs



Source: Green Street Advisors

The absolute value of MVA in the cases above is not insignificant. However, whilst MVA obviously affects NAV, it is still dominated by underlying property price appreciation. It therefore becomes clear that a relatively poor management team with custody over quality assets in superior locations will still achieve superior outcomes (NAV growth) compared to a great management team operating in locations with poor fundamentals.

This means that for an analyst and investment manager, management quality is very important but it is only part of the bigger picture. Supply and demand fundamentals will continue to be the key driver of investment returns.