CHARTA LEARNING · INTERVIEW PREPARATION

Real Estate Fundamentals and Fund Economics

Interview preparation summary · RE track

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INT.EF.1.a · Property investing

Split a property's total return into income and capital return and say how property type changes the mix and the risk.

Property return has two parts. Income return is net operating income (NOI, rent less operating costs the landlord cannot recover) divided by the opening value; capital return is the change in value over the period; the two add to total return. Because value is roughly NOI divided by the capitalisation (cap) rate, capital return comes from NOI growth, from a change in the cap rate, or both, and the two can offset. Property types differ in the mix: a long lease to a strong tenant at a fixed rent is mostly income with little growth, while a market with short leases and tight supply offers rent growth but less certainty. Offices, retail, logistics, residential, hotels and alternatives also differ in obsolescence and capex. The usual mistake is to quote the yield as the return and forget that a modest rise in the cap rate can erase years of income. In an interview, always split a return into yield, growth and yield shift.

WORKED EXAMPLE: TWO ASSETS, ONE 50 BASIS POINT SHOCK

An interviewer gives you two invented assets, each bought for 40.0m. Marlow Park is a logistics warehouse with year-one NOI of 2.0m, expected to grow 3% a year. Tarn Centre is a shopping centre with year-one NOI of 3.0m, expected to fall 2% a year. Compare one-year total returns, then ask what a 50 basis point rise in the cap rate does. Convention: value equals next year's NOI ÷ the cap rate, the cap rate is otherwise unchanged, ignore costs, tax and debt.

Answer: With the cap rate unchanged, Marlow Park returns about 8.0% and Tarn Centre about 5.5%. After a 50 basis point rise in cap rates, both total returns are negative: about minus 1.4% and minus 0.6%.

Interview tip: Say: I split any return into yield, income growth and yield shift. The high-yield asset is not automatically better if its income is falling, and a half-point move in the cap rate can cost more than a year of income.

INT.EF.1.b · Property investing

Place a deal on the strategy spectrum from core to opportunistic and explain how leverage and business plan drive its return and risk.

Strategies are labels for where return comes from and how much risk is taken. Core assets are fully let, well located, with long leases to good tenants, low leverage (often under 40% loan to value) and returns mostly from income. Core-plus adds modest leasing or capex risk. Value-add buys assets with vacancy, short leases or needed refurbishment, uses moderate to high leverage and earns much of its return from raising net operating income and then selling. Opportunistic covers development, distressed purchases and unfamiliar markets, with high leverage and wide outcomes. Target returns rise down the list, typically from high single digits to the high teens, but so does dispersion. Leverage multiplies the effect of any shortfall on the equity, roughly by one divided by one minus the loan to value ratio. The usual mistake is to label a deal by its leverage alone. In an interview, name the driver of return and ask what happens if it fails.

WORKED EXAMPLE: CORE VERSUS VALUE-ADD WHEN THE PLAN FALLS SHORT

A core fund buys at 30% loan to value, expecting an unlevered total return of 6.5% a year, with debt at 4.5%. A value-add fund buys at 60% loan to value, expecting an unlevered 9.0%, with debt at 6.0%. Compare the levered equity returns, then see what happens if each asset's unlevered return comes in 3.0 points below plan. Convention: one-year view, interest-only debt, levered return equals (unlevered return minus loan to value times debt cost) ÷ (1 minus loan to value), ignore fees and tax.

Answer: On plan, core earns about 7.4% and value-add 13.5%. If each asset is 3.0 points short, core earns about 3.1% and value-add 6.0%, so the value-add swing is wider (7.5 points against 4.3).

Interview tip: Say: the strategy label tells me where the return comes from. I always show the equity return on plan and 3 points below plan, because leverage and the business plan decide the spread between them.

INT.EF.1.c · Property investing

Explain how a property investment differs from a buyout of an operating company in cash flows, valuation, leverage and exit.

A property buyer owns an asset whose cash flow is largely set by leases, so income starts on day one, while a buyout owns a business whose earnings come from operations. Value follows income capitalisation: NOI divided by the cap rate, equivalent to an earnings multiple of one divided by the cap rate (a 5% cap rate is 20 times). Debt is usually secured on the asset, sized by loan to value, interest cover and debt yield, and often has no recourse beyond the property. Purchase costs such as transfer taxes and fees are large and sunk, and exit value depends heavily on the market cap rate, which the owner does not control. Operational skill still matters, in leasing, capex and development, and operating assets such as hotels look more like companies. The usual mistake is treating a cap rate move as noise. In an interview, show that you can value by NOI and cap rate and size what a yield shift does to equity.

WORKED EXAMPLE: YIELD AFTER COSTS AND THE LEVERAGED HIT TO EQUITY

Cobham Court, an invented office building, is offered at 50.0m with year-one NOI of 2.6m. Buying costs are 6.8% of price. A fund would borrow 27.5m (55% of price). Work out the cap rate, the yield after costs, the equivalent earnings multiple, and what a 25 basis point rise in the exit cap rate does to the equity. Convention: NOI unchanged, no interim cash flow, sale costs ignored, one price at exit.

Answer: The cap rate is 5.2%, the yield after costs 4.87%, and a 25 basis point rise in the exit cap rate cuts value by 4.6% and the equity by about 22.0%.

> **Interview tip:** Say: in property I value by NOI over the cap rate, I count the buying costs, and I stress the exit yield first because with leverage a small move in value is a large move in equity.

INT.EF.2.a · Funds and structures

Describe closed-end, open-ended and joint-venture structures and trace how fees and carried interest turn a gross multiple into a net multiple.

Real estate capital is organised in a few ways. A closed-end fund raises commitments, invests during an investment period, and returns capital by a fixed end date (often eight to ten years, with extensions), which suits value-add and opportunistic strategies. An open-ended fund lets investors subscribe and redeem at net asset value, which suits core strategies but creates redemption queue risk in stress. A joint venture pairs capital with an operating partner who sources and runs the asset and usually co-invests a small share. A separate account serves one large investor. The manager earns a management fee (typically a percentage of commitments, then of invested capital), sometimes transaction or asset-level fees, and carried interest above a preferred return. Fees reduce what is invested and what is returned, so net multiples are well below gross. The usual mistake is quoting gross returns. In an interview, show gross to net in numbers.

WORKED EXAMPLE: FROM A GROSS MULTIPLE TO A NET MULTIPLE

Alder Value Fund, an invented closed-end fund, has commitments of 200m. It charges 1.5% a year on commitments for a four-year investment period, then 1.25% a year on invested capital for three more years, with invested capital averaging 160m in that period. Fees are paid from commitments, and the rest is invested at a gross multiple of 1.9x. Carry is 20% of profit, the 8% hurdle is cleared and the catch-up is complete. Find total fees and the net multiple to investors. Convention: multiples on total contributions, ignore the timing of cash flows and any other costs.

Answer: Fees total 18.0m and carry about 29.2m, so a 1.9x gross multiple on invested capital becomes about 1.58x net on the 200m the investors committed.

> **Interview tip:** Say: gross is the asset-level multiple. I take off fees first, because they shrink the capital invested, and then carry on the profit, to reach what the investor actually keeps.

INT.EF.2.b · Funds and structures

Run a joint-venture waterfall with a preferred return and a promote, and explain how its terms change the operator's incentives.

A waterfall sets the order in which cash is shared. A typical joint-venture version has tiers: first return of capital and a preferred return (pref, a minimum annual return, usually compounding) to all partners pro rata; then profit above the pref is split, with the operator taking a promote (a share of profit larger than its capital share) as an incentive. Further tiers can raise the promote when investors reach a higher internal rate of return (IRR) hurdle. A catch-up lets the operator take a larger share

after the pref until it holds its target share of total profit. Hurdles measured only by IRR can reward an early sale, so investors often add a minimum equity multiple, and some promote is held back until the end or subject to clawback. The usual mistake is to apply the promote to total profit instead of only to profit above the hurdle. In an interview, walk the tiers in order.

WORKED EXAMPLE: A THREE-YEAR JOINT-VENTURE WATERFALL

Fenwick Yard, an invented logistics asset, is owned by a joint venture with 20.0m of equity: the investor puts in 18.0m (90%) and the operator 2.0m (10%). Terms: an 8% preferred return, compounding, shared pro rata; then profit above that is split 80% pro rata to both partners and 20% to the operator as promote. There is a single cash flow of 29.0m from a sale at the end of year three. Work out each partner's proceeds and the investor's IRR. Convention: no interim distributions, ignore fees and tax.

Answer: The investor receives about 25.4m (IRR about 12.2%) and the operator about 3.6m, of which 0.76m is promote.

> **Interview tip:** Say: first the capital and pref go to everyone pro rata, then I apply the promote only to what is left above the hurdle. Then I check the operator's multiple against the investor's.

INT.EF.2.c · Funds and structures

Compare a listed REIT with a private vehicle and use the discount to net asset value to read what the market is pricing.

A real estate investment trust (REIT) is a listed company that owns property and, to keep its tax status, typically distributes most of its taxable income. Its shares trade daily at a price that can sit above or below net asset value (NAV, the appraised property value less debt, per share). Private vehicles report appraisal-based values that move slowly, so their volatility looks lower than the underlying risk (appraisal smoothing), but investors cannot sell on a screen. A discount to NAV means the market values the properties lower than the appraisers, or is pricing debt, fees, tax leakage or poor management. To read it, add the market value of equity to debt and divide net operating income by that implied property value to get an implied yield, then compare it with the book yield. The usual mistake is to call every discount a bargain without testing the appraisals. In an interview, compute the implied yield.

WORKED EXAMPLE: THE YIELD IMPLIED BY A REIT'S DISCOUNT

Brindle Property Trust, an invented REIT, has 120m shares, properties appraised at 1,000m, debt of 400m and annual NOI of 50.0m. Its shares trade at 4.20. Find NAV per share, the discount, and the property yield the market is implying. Convention: NAV is appraised value less debt, ignore other assets and liabilities, deal costs and tax.

Answer: NAV is 5.00 a share, the shares trade at a 16.0% discount, and the market is implying a property yield of about 5.53% against a book yield of 5.00%.

> **Interview tip:** Say: a discount is not automatically a bargain. I convert it into an implied yield, compare that with recent sales evidence, and ask whether the appraisals, the debt or the management explain it.