

# Cornerstone Real Estate Advisers

## Real Estate Securities Team



Scott Westphal

David Wharmby

**Scott C. Westphal**, CFA, CPA, managing director of Cornerstone's real estate securities investment management unit, is responsible for the creation and management of real estate securities portfolios for the firm's institutional and retail client base. Prior to joining Cornerstone in 1999, Westphal served as a senior executive and portfolio manager for JLW Capital Management as well as for Cohen & Steers Capital Management. Prior to his position at Cohen & Steers, Westphal was a portfolio manager for the IBM Retirement Fund's \$2.5 billion real estate portfolio, where his responsibilities included investments in direct properties, joint ventures and REITs. He was also responsible for the first property for share exchange negotiated with a publicly traded U.S. REIT.

**David Wharmby**, CFA, vice president, portfolio management, real estate securities, is responsible for the management of the global real estate securities strategy and is a senior member of the U.S. REIT strategy team. He previously had research coverage responsibilities for the office and multifamily sectors. Wharmby began his career at Cornerstone in 1996, serving in acquisition underwriting and asset management roles before joining the securities team. Prior to joining Cornerstone, Wharmby was assistant vice president with L.W. Ellwood & Co./Coopers & Lybrand where he was responsible for managing due diligence and valuation services for institutional investors.

Recently, *Geoffrey Dobrman*, publisher and editor-in-chief of *The Institutional Real Estate Letter – North America*, spoke with **Scott Westphal** and **David Wharmby** of Cornerstone Real Estate Advisers. The following is an excerpt of their conversation.

*Tell me a little bit about Cornerstone's real estate securities business, especially how the securities side of the business came to be.*

**Westphal:** Cornerstone realized that in order to cover the entire spectrum of real estate investment opportunities, we would need to offer securities as well as private equity products. I was recruited in 1999 to build out the real estate securities business, which I did by first developing a successful U.S. REIT business, and subsequently made the strategic decision to develop a global platform.

*How is the global side of the business structured?*

**Wharmby:** We believe real estate is a localized asset class, where a keen understanding of the local market and real estate fundamentals is critical. Accordingly, we retained seasoned real estate investment professionals to manage our European and Asian investment platforms. To lever the strengths of those senior people, we integrated them into our overall investment management process. The global strategy is managed in a team approach, with myself as portfolio manager responsible for making sure the regional teams are driving the best ideas into the portfolio.

**Westphal:** We invest a lot of time in communications across the globe — in fact we talk between offices almost every day — to be sure that not only are the best ideas making their way into the portfolio, but that the analysts in each region are aware of themes that exist or

are evolving in other regions and can react accordingly. We are integrated with Cornerstone's real estate economic and market research group, lead by Michael Gately and Jim Clayton. Macroeconomic and regional market assessment is especially important in a global context. Cornerstone's ability to leverage and incorporate this analysis within our top-down process is a critical part of our methodology.

*Where are your real estate securities teams located?*

**Wharmby:** Scott and I, as portfolio managers, work out of our Stamford office. In addition, the securities team has personnel and offices in Hong Kong and Amsterdam. From Amsterdam, we can effectively cover Europe while our Hong Kong office covers Asia and Australia.

*Investors today are very concerned about the strength of balance sheets, both of their investment managers and of financial institutions, of which MassMutual is one. How do you stand with respect to those issues?*

**Westphal:** Cornerstone has a very strong balance sheet, and we are functioning extremely well in this environment. One reason we have been able to weather the storm is the financial strength of our parent company, MassMutual, a highly rated U.S. insurance company. MassMutual has the advantage of being a mutual company, and can therefore take a long-term view of policyholder value. That provides Cornerstone with a parent company that is well capitalized and able to support our efforts in a meaningful way. So in many respects we think the parent/subsidiary relationship that we enjoy today is really ideal.

**Wharmby:** It is also worth noting that Cornerstone does not have any debt on its balance sheet. Our clients appreciate the stability our financial strength gives us. We have been able to manage the responsibilities to our clients in an uncompromised way. We remain fully staffed, and we are committed to expanding our services to investors. This places us in a strong position to be consolidators in the marketplace, whether on the security side

### Why Invest in Real Estate Securities?

- > Real estate securities provide immediate exposure to the \$5.2 trillion global institutional property market.
- > Securities are publicly traded, so investors can quickly gain exposure to targeted geographic regions and real estate sectors.
- > Real estate securities provide competitive returns and high income yields.
- > Real estate securities reduce portfolio risk.
- > The addition of global real estate securities enhances the risk-adjusted returns of a mixed-asset portfolio.

### Why Invest with Cornerstone Real Estate Advisers?

The years ahead will be a true stock-pickers market. Finding those companies positioned to take advantage of the opportunities available will take deep knowledge of real estate fundamentals as well as equity markets. The Cornerstone securities team possesses both the private and public real estate knowledge needed to find the companies that will flourish in today's and tomorrow's world.

of the business or the direct side of the business.

*What skills do your team members bring to the table?*

**Westphal:** Cornerstone is an integrated real estate advisory firm with broad experience and research capabilities in direct real estate markets and public securities. Our underlying belief is that a securities group should not be a stand-alone entity, but rather should be a fully involved member of a real estate advisory organization that takes a coherent, holistic approach to investment in real estate.

**Wharmby:** The securities team is made up of real estate investment professionals, many of whom have direct bricks-and-sticks experience to complement their security analysis skills. Each office has senior personnel with over 10 years of real estate securities experience. In addition, a number of our people have previously worked together resulting in a healthy team dynamic as well as providing a deep bench of portfolio management expertise.

*Why is it important to have direct real estate experience?*

**Westphal:** Having this skill set allows us to better understand the operating characteristics of the properties that public companies own and how economic and real estate

cycles affect their performance. The real estate securities group has the advantage of being able to capitalize on the efforts of our well respected real estate research group, as well as leverage the hands-on experience of our direct real estate group. We have regional offices across the United States, and the direct team is in the market every day. This daily market interaction allows us to provide our investors timely and relevant information associated with the property markets in which our targeted companies are investing.

**Wharmby:** We also have a wide variety of skill sets within the real estate securities team, including former architects, appraisers, asset managers and people involved in development activities. Additionally, we have people who have completed acquisitions both domestically and internationally. The ability of a securities group to leverage that type of information is unique, and having that information enables us to make the best investment choices we can at any given point in the cycle.

*What specifically do you do to integrate the operations of securities with the private side of the business?*

**Westphal:** We leverage both our research and private investment teams for the types of market research that allow us to make knowledgeable

investment decisions. In a market as it exists today, having both proprietary top-down research and on-the-ground bottom-up real time data is crucial. One important tool involves our ability to overlay our economic and property forecasts on the portfolios of specific REITs. This provides us with a forecast for the REIT's property performance that is weighted to reflect the specific market and property type representations in the real estate company's portfolio.

*How often do you interact with these two groups?*

**Wharmby:** We hold research calls at least once a week to talk about everything that is going on in the real estate securities markets, as well as what is going on in the direct side of the business. In addition, each analyst interacts with the direct side on an ad hoc basis.

**Westphal:** To give you an example, our analyst, who covers the apart-

ment and health care companies for us, might have a call to discuss apartment traffic trends in particular sub-markets. This type of nuanced real time data that is not readily available from companies and third-party providers of apartment data can allow us to identify trends that will impact earnings before it is apparent to the rest of the market place. On the direct side, our regional offices report to us transactions that they become aware of. They identify the building, the cap rate, the buyer, the seller and any other relevant information that they can for us. We are thus getting very timely and relevant information from the direct side of the business at a time when it is very difficult to judge where cap rates are today and more particularly where they are going in the future.

*You are not investing globally on the private side of the market yet. How do you deal with this in a global strategy?*

**Wharmby:** The nature of the information and the way the markets function internationally is somewhat different than those in the United States. The companies tend to have more broad diversified real estate portfolios than U.S. firms. The available information on the property market is not as transparent and consistent and is more influenced by macroeconomic dynamics. That is one of the reasons that we have structured the team the way we have with senior analysts to interpret the impact of macroeconomic data on local real estate markets. Their contacts and expertise give us that local, boots-on-the-ground, experience needed to navigate the global markets. The top-down analysis is a particularly important part of the global portfolio construction process.

*What metrics do you ultimately use to decide when and where to invest?*

## Global Securities Show Strength Going Into Second Half of Year

The unprecedented liquidity flooding the system has had its desired positive impact. Funding channels have opened up as evidenced by recent successful capital raisings by property companies globally. As balance sheet concerns are slowly being removed, we believe further upside to share prices will be driven by each company's ability to refocus again on earnings growth during the eventual economic recovery. Recent capitalization events point to discrepancies in companies' abilities to obtain funding due their size, quality, track record, reputation, etc. We believe many companies which have seen significant share price recoveries based on temporary access to capital will find themselves in a box as they prove unable to execute on a growth strategy. We intend to avoid these traps and remain focused on fundamental analysis to uncover companies with the ability to generate long-term, sustainable earnings and value creation. We believe that the ability of the balance sheet to support external growth will drive a distinction between companies over the coming quarters. Companies with superior management teams and strategies; strong balance sheets and ample dry powder to take advantage of pricing dislocations in the real estate transaction markets; and a healthy base of a high quality existing portfolio, should be able to drive outsized gains as global economies right themselves.



Source: Cornerstone, SNL, Company filings

**Westphal:** We believe it is important to remember that in addition to being real estate portfolios, these securities are also equities and therefore require careful analysis of the capital structure, management, and strategy as well. As such, our analysis of the underlying fundamentals of the real estate portfolios must be integrated with elements of traditional equity analysis.

We look at a variety of metrics because we've found through our years of experience that no single metric can be counted on to always give an appropriate buy or sell signal. The fourth quarter of 2008 and the first part of 2009, when there was a dearth of transactional data available, is a perfect example of a time when the capital markets were the primary driving force in a stock's performance rather than the net asset value. During this time, the strength of a company's balance sheet drove its market price more than anything else. So we use multiple metrics relating to the capital market cycles and also to the real estate itself, but we never rely exclusively on one metric.

**Wharmby:** Our process takes a longer-term view of return on equity, and we attempt to look through the temporary impact of financial engineering and short-term programs that companies might have implemented. We spend a tremendous

amount of time on fundamental real estate research and really trying to understand companies' business and financial strategies. Our process and philosophy is also adaptive, whereas real estate fundamentals underpin our research process, we also recognize that the economic cycle, real estate cycle and a capital markets cycle all affect real estate — and listed real estate specifically — differently. It is our job to understand the companies' business and financial strategies, their ability to execute given where we are in the economic, real estate and capital market cycles, and how these cycles interact.

**Westphal:** One of the precepts that underlie our process is that we do see real estate companies as being in the broad investing business. So, as part of our capital markets analysis, we need to have a very thorough understanding of not only their access to capital, but also how much they can access. We evaluate how efficient the companies are at accessing capital, and how proficient they are at deploying that capital. Our assessment is not just a snapshot in time when the asset is acquired, but is a long-term view of their overall business strategy and how they can effectively increase the return on assets and maintain that low cost to capital going forward. Ultimately, this is how they generate returns for their shareholders.

*Where do you see the business going from here?*

**Westphal:** The Cornerstone securities team has put in place the framework to capitalize on the future growth within the global real estate securities market. We have a senior team with deep real estate experience located in the markets in which they cover. We have a strong track record in both our global and U.S. strategies, which are available to retail and institutional investors via a subadvised mutual fund or separate account. The real estate securities market is a robust vital part of the investable real estate universe. The Cornerstone securities team is ideally positioned to partner with investors to capitalize on the opportunities that we believe exist prospectively within this space. ♦

#### Corporate Overview

##### Cornerstone Real Estate Advisers

was established in 1994 to provide private real estate equity investment management services for its parent corporation, Massachusetts Mutual Life Insurance Company (MassMutual), and tax-exempt and taxable institutions. Since then, it has added management of public real estate securities to its array of services.

To best meet clients' needs, Cornerstone offers separate account management, real estate funds, including a series of strategically focused closed-end funds and has become the subadviser for a public real estate securities mutual fund.

Cornerstone offers its services to public and corporate pension funds, endowments, foundations and insurance companies. As of the second quarter of 2008, Cornerstone had approximately \$9.4 billion in public and private real estate investment.

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