REITs

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Multifamily REITs: Revenue Management 101

We recently hosted a comprehensive event featuring the two companies leading the development and implementation of revenue management software for the multifamily industry – RealPage (YieldStar) and the Rainmaker Group (LRO). This half-day tutorial provided an opportunity for participants to compare and contrast the two systems, and we discuss our observations in this report. However, the crux of this effort is not to proclaim one system over the other, but to highlight the benefits of using revenue management in general, and what might be the future and challenges for the tool as it gets rolled out throughout the US.

The core idea of revenue management for multifamily comes from the airline and hospitality industries, where prices change daily based on supply and demand. Because multifamily is such a different animal, its revenue management systems had to be built literally from the ground up. There is very little crossover in the root functionality beyond the basic concept.

Plenty of Upside

The bottom line is that we think multifamily revenue management, in connection with a hands-on approach, is proving itself a worthy tool for the industry – with revenue lift averaging something north of 1% depending on how it is measured. And the more it is used, the better and more efficient the overall business of apartments will become. In some cases it is a push – using revenue management to set rents results in no meaningful upside. This happens about 30% of the time, and is mainly a function of strong in-place property management personnel. But the problem is, good employees tend to leave (assuming 60%+ employee turnover) whereas revenue management does not. So even in those cases where revenue lift from the software is marginal, it still makes sense to consider utilizing revenue management.

It is estimated that roughly 7% of US apartment units that can reasonably benefit from revenue management are on a system. Management at RealPage believes that can increase to 80% in five years, while Rainmaker thinks it is something closer to 60%-70% in eight years. But either way, there appears to be plenty of growth potential for revenue management in the

Summary

- This report provides a comprehensive overview of multifamily revenue management – the industry's state of the art tool aimed at maximizing property-level revenue. The report comes in the wake of a half-day tutorial we hosted recently, which included interactive presentations from the senior teams at both RealPage (owner of YieldStar) and the Rainmaker Group (which runs LRO and plans to buy it outright in three years).
- While this report touches on the subtle differences between YieldStar and LRO, the main objective is to get the word out on the concept of revenue management and to point out where we think it is headed. Both management teams presented extremely well and demonstrated a deep understanding and enthusiasm for revenue management and the multifamily industry in general.
- One message from both companies was to dispel the notion of revenue management as a "black box" – the argument being that it is a process with ongoing human interaction, and not a process based on blind faith.
- Interestingly, revenue management beats the performance of non-revenue management properties about 70% of the time – it is a push for the other 30%, depending on the strength of property personnel. We discuss anecdotes and factoids like this throughout the report.

multifamily sector. We see this enhancement to efficiency in multifamily pricing as an important positive for the industry, and the public REITs that will collectively benefit as the concept of revenue management becomes increasingly mainstream. However, accomplishing this growth does not come without challenges which we discuss in a separate section below.

The Basic Model

It is beyond the scope of this report, and the minds of 99.9% of Americans, to discuss the coding details of revenue management. Suffice it to say it is a complex and mathematical process that takes into account a variety of property-specific, local and market fundamental inputs to *suggest* an optimal net effective rent for a given unit at a given property. Such factors include:

- Two to three years of property-specific history (occupancy, traffic, close rates, etc.) to gauge tenant behaviors.
- A “snapshot” of the current environment as a supplement to the history.
- A short- and long-term forecast period based on this history.
- Rent, occupancy and concession data on competitive product in the immediate area of the subject asset.
- Market-level multifamily fundamental statistics and economic data/trends.

Both organizations employ PhDs in mathematics –the genius behind the coding. Rainmaker (LRO) has internal expertise across many different industries to build and modify its multifamily product, whereas RealPage (YieldStar) is centered in the multifamily industry only. YieldStar and LRO have differing means to capture this information, and contrasting ways by which the data is manipulated to provide an optimal rent for a given apartment unit. However, the basic process is shared by both – that revenue management is an engaged process that requires an expert and point of contact within each company using the tool to provide constant oversight and feedback. This is a very important point – revenue management improves the pricing process, it does not replace it.

Rents are determined by YieldStar and LRO on a net-effective basis (no concessions) and must be accepted by the operator of the multifamily property for the process to be complete. Acceptance rates vary widely, but have generally been trending up. At this early stage of revenue management evolution, the acceptance range seems to be within 60%-90%. In addition, the software naturally becomes more intelligent and predictive the more it is used. With each passing day, current fundamental nuances and fresh operating data are superimposed with history to formulate a more thorough understanding of how to pinpoint the optimal rent. A parallel analogy may be this: Your grandfather will always be smarter than you.

Comparing YieldStar and LRO

As we discussed earlier, we believe there is plenty of room for YieldStar and LRO to grow independent of one another as the multifamily industry increasingly accepts revenue management as the rule, and not the exception. The growth prospects – from 7% of available apartment units to (fill in the blank!) – may even be too large for a single company to manage. In our view, YieldStar and LRO has their own unique strengths and weaknesses. And while combining the two organizations may create some efficiency, we think the benefits of the friendly competition they share will motivate both to improve – the latter is the better formula at this stage, in our opinion. Here are some of the differences we detected between the two revenue management competitors.

Cycle Tested

Archstone-Smith, in conjunction with Equity Residential (EQR), rolled out LRO in 2002, three and a half years before Camden Property Trust (CPT) fully introduced YieldStar at the end of 2005. As such, LRO (which Rainmaker plans to purchase outright in 2011) has seen an entire peak-to-trough cycle, whereas RealPage's YieldStar has not. In our view, there is no reason to believe revenue management will work any differently during good or bad times, but one may make the argument that LRO has the advantage of a longer history.

Currently, LRO has been deployed or is in the process of being deployed for 438,000 units, with over 300,000 units in the pipeline of potential business. YieldStar has 348,000 units deployed or under deployment, and over 400,000 units of potential business in its pipeline. All of this adds up to about 1.5 million units of existing and potential business, although the pipeline numbers represent some double counting.

Depth of Data

YieldStar has access to 50 years of market data from M/PF research (owned by RealPage as well), while LRO's historical inputs is constrained to the data collected within its system of clients (not a small data set, either). Since recent and local operating statistics play the most critical role in both products, having access to deep history is probably a small advantage for YieldStar – although it certainly doesn't hurt the marketing of the product. Further, we understand that LRO places somewhat more emphasis on comparable data from neighboring properties, which risks being tainted or unreliable. Knowing this, LRO makes an extra effort to ensure the quality of the comp data used by the LRO software is legit.

Target Occupancy

Both companies are focused on maximizing *revenue*, which is a balance of rent levels and occupancy. However, the YieldStar product involves a target occupancy which is pre-set by the client, while LRO has no such functionality.

We believe there remains an entrenched and trivial view that property revenue is maximized at 94%-95% occupancy. In some cases, revenue will be maximized at, say, 91% depending on several factors including prevailing market conditions. We think YieldStar's "target occupancy" amounts to handholding – a stepping stone to slowly veer multifamily operators away from this mindset. The target occupancy can be changed with little effort, but it does represent the starting point for YieldStar that may provide a psychological benefit when it comes to marketing the product. In the absence of a target occupancy, LRO's approach might be a tougher sell, particularly to less sophisticated owners/managers (see challenges section below). However, we think LRO makes the correct point that there is no level of occupancy that universally maximizes revenue.

Revenue Uplift History

YieldStar markets its product to expect a minimum of a 1% revenue lift (versus a comparable property without revenue management), while LRO presented data during our tutorial showing nothing lower than a 3% lift. Based on this, it might be easy to conclude that LRO is doing better. But the reality is that measuring the benefits of revenue management is difficult, and creating a pure apples-to-apples comparison is virtually impossible. Among other things, there are many human factors that muddy the analysis. We think the consistent outperformance from both YieldStar and LRO, regardless if it is 1% or 3%, represents the true litmus test. Both teams shared the view that revenue management beats non-revenue management properties about 70% of the time (as discussed earlier), and had data to support it. So we are calling this a push.

In Exhibit 1 we provide the results of several pilot tests with LRO. These results, which show the aforementioned minimum revenue lift of 3%, are compared with the clients own controlled (non-revenue management) communities. Importantly, these are not comparisons against data provided by a third-party, which could be unreliable.

Exhibit 1: LRO Pilot Test Results

Study	Test Properties	Control Properties	Time Period	Results
ASN Alpha Test	5 communities in 3 markets	5 pre-selected control properties	May-Oct 2001	4.05%
Pilot I	6 communities in 5 markets	6 pre-selected control properties	Jun 03 - Feb 04	3.85%
Pilot II	6 communities in 2 markets	6 pre-selected control properties	Jan 04 – Apr 04	3.11%
Pilot III	6 communities in 3 markets	6 pre-selected control properties	Apr 06 – May 06	5.2%
Pilot IV	7 communities in 4 markets	7 pre-selected control properties	2006	3.2%
Pilot V	6 communities in 4 markets	6 pre-selected control properties	Jan 07 – Jun 07	3.7%
Pilot VI	8 communities in 3 markets	8 pre-selected control properties	Jun 07 – Nov 07	3.9%
Pilot VII	6 communities in 3 markets	6 pre-selected control properties	Nov 07 – May 08	3.0%

Source: The Rainmaker Group.

Head-to-Head

Finally, in head-to-head competition at the public REIT level, two REITs put both products to the test before committing to a decision on which one to purchase. When the dust settled, one REIT chose LRO and the other chose YieldStar. We think this further speaks to the neutrality of the products relative to one another.

Other Considerations

Below we discuss several additional issues that were raised during our group tutorial session, and provide our own perspective on each.

Anticipated Penetration of Revenue Management

We mentioned earlier that about 7% of apartment units in the US are using some form of revenue management today. With about 15 to 17 million of non-affordable apartments in the US, an increase to a 60%+ share should represent several orders of magnitude of an increase to the business of LRO and YieldStar.

Separately, we note that size really doesn't matter when it comes to the client, with one property owner on revenue management running a portfolio of just three communities. The product is priced on a per-unit basis, so as long as the owner/operator can employ an internal revenue management specialist, the economics have a chance to make sense. There are challenges, of course, and other entrants will likely come along to compete for a share. But we see this as a win-win for both the providers and users of revenue management.

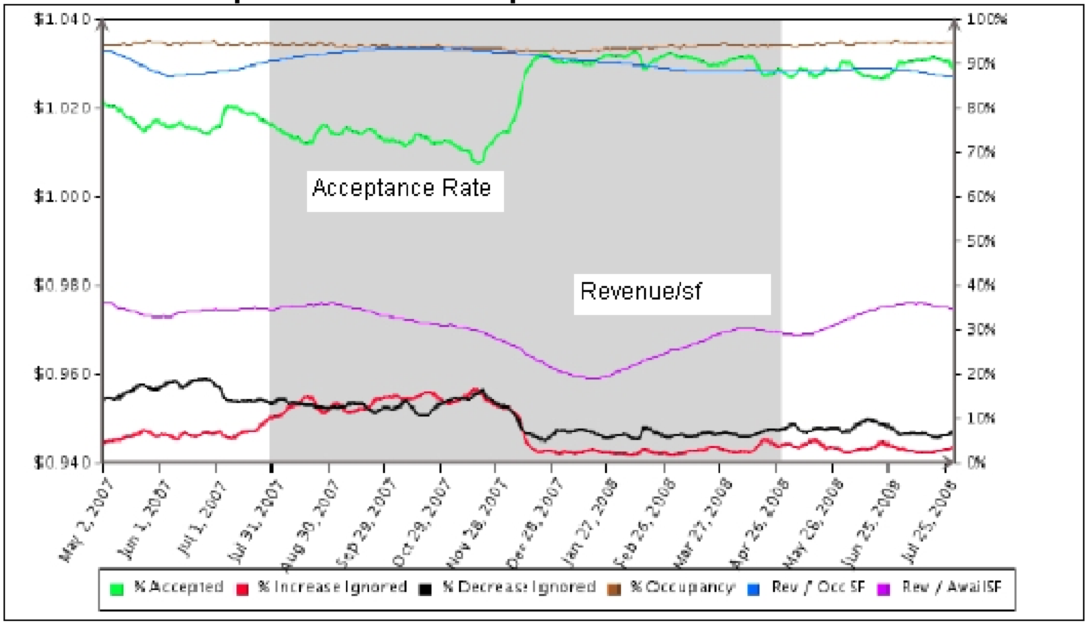
"Change Management": Acceptance Rate a Key Factor

Earlier, we mentioned the uninformed view, which has been passed down through generations, that there is a set occupancy rate that corresponds with maximum revenue, and this sometimes presents a hurdle for an owner/operator to buy into revenue management. But even after this hurdle is cleared, it still may take time to shake old habits. Both YieldStar and LRO provide a suggested rent level for a particular unit, but it is up to the property manager to either accept or reject that suggestion. "Change management", that is, guiding clients through the cultural changes required to properly implement revenue management, is a focus of both companies.

A key to change management is the acceptance rate, or the percentage of times a client owner/operator actually uses the rent that the revenue management system suggests. Acceptance rates can run in a large range, but we think the bulk of it is from 60% to 90%. YieldStar and LRO are seeing acceptance rates climb as clients become more comfortable with the product, but sometimes it takes a little kick in the butt.

A good example of this was demonstrated by YieldStar, which we show in Exhibit 2. This client's acceptance rate was hovering at about 70% in late 2007 and revenue per square foot was flat or declining. After being encouraged to increase the acceptance rate to over 90%, revenue eventually started to trend up meaningfully. (There are several other lines on the graph, but these are the most important for this discussion.) And while this is a single example that could have been influenced by a variety of factors, the fact that YieldStar and LRO have repeatedly demonstrated similar results gives credibility to the visual provided by Exhibit 2.

Exhibit 2: Acceptance Rate Example for YieldStar



Source: RealPage.

Protects Against Fair Housing-Related Lawsuits

A potentially valuable side-benefit of revenue management is that it is a completely objective process, and hence has protective characteristics relative to the Fair Housing Act. Legal troubles related to Fair Housing are not foreign to multifamily owners, so this could be a secondary, albeit valuable benefit of implementing revenue management.

Challenges in Getting Revenue Management Rolled Out

While we see great upside potential for the industry through the implementation of revenue management, we think there are two particular segments of the US multifamily business that could present headwinds against revenue management reaching the 60%+ plateau.

- **Small Owners:** Deep-seated beliefs have many multifamily owners/operators set in their ways about running a collection of apartment communities, which we touch on throughout this report. But about 30% of US apartment units are in communities of 50 homes or less (still a fragmented industry), and we think this cohort of the market might be most susceptible to the old school way of doing business.
- **Properties Managed by a Third Party:** Another challenge is the 15%-20% of US apartment units that are managed on a fee basis. With a somewhat disinterested property owner being once removed from the business, spending the time and energy to investigate revenue management could be a tough sell. Meanwhile, since the third-party manager in these cases charges a fee to do its job, they may be even less motivated to incorporate revenue management.

Possible Future Improvements/Enhancements

Beyond the immediate opportunity of conventional multifamily housing in the US, we expect revenue management to continuously improve and expand its capabilities to appeal to an even greater audience over time. There is no urgency given the long list of potential new clients in the US, but here are some expansion/improvement ideas that we think could be on the longer-term horizon:

- **The Pricing of Unit Upgrades/Amenities:** As it stands now, revenue management is conducted off of the base unit with no improvements (that is, no granite counters, hardwood floors, or crown molding) or special features (pools, gyms). Once the rent on a base unit is determined, a premium is layered on top of the calculated base rent to complete the process. Future versions may incorporate upgrade pricing directly into the revenue management process.
- **Other Property Segments:** We understand that the process of creating a modified revenue management tool for such things as student and affordable housing is already happening, but the timeframe is unknown. Such additions to revenue management capabilities could expand the pipeline substantially. Other possible real estate applications include manufactured homes and self storage, both of which typically have month-to-month leases.
- **International:** Assuming a successful track record in the US over the next 10 years, we suspect other countries would start to show interest. With plenty of opportunity in the US at this point, we don't believe international expansion of revenue management is currently being contemplated. But with the globalization of real estate, it seems like an obvious next step several years down the road.

		2-Sep		FFO			P/FFO						Mkt Cap
REITs	**Rating**	**Price**	**Target**	**2007E**	**2008E**	**2009E**	**2007E**	**2008E**	**2009E**	**Div**	**Yld**	**NAV**	**($mm)**
Acadia Realty (AKR)	Outperform	$23.87	$28	$1.30	$1.32	$1.47	18.4	18.1	16.2	$0.84	3.5%	$26.09	787
American Land Lease (ANL)	Market Perform	$22.00	$23	$1.01	$0.64	$0.94	21.8	34.4	23.4	$1.00	4.5%	$26.26	174
Apartment Investment & Management (AIV)	Underperform	$35.47	$28	$3.28	$3.34	$3.45	10.8	10.6	10.3	$2.40	6.8%	$43.82	3,114
AvalonBay Communities (AVB)	Outperform	$99.92	$109	$4.61	$5.09	$5.44	21.7	19.6	18.4	$3.57	3.6%	$119.24	7,698
Brandywine Realty (BDN)	Market Perform	$17.48	$16	$2.55	$2.34	$2.41	6.9	7.5	7.3	$1.76	10.1%	$25.17	1,549
BRE Properties (BRE)	Market Perform	$48.07	$47	$2.59	$2.79	$2.91	18.6	17.2	16.5	$2.25	4.7%	$61.03	2,452
Camden Property (CPT)	Market Perform	$48.87	$51	$3.66	$3.56	$3.70	13.4	13.7	13.2	$2.80	5.7%	$63.33	2,598
Cedar Shopping Centers (CDR)	Market Perform	$13.42	$14	$1.22	$1.23	$1.33	11.0	10.9	10.1	$0.90	6.7%	$14.92	597
Cogdell Spencer (CSA)	Market Perform	$19.39	$17	$1.17	$1.23	$1.32	16.6	15.8	14.7	$1.40	7.2%	$19.83	232
Colonial Properties (CLP)	Underperform	$19.01	$21	$1.78	$2.17	$2.24	10.7	8.8	8.5	$2.00	10.5%	$30.69	899
Corporate Office Properties (OFC)	Outperform	$39.50	$45	$2.24	$2.45	$2.70	17.6	16.1	14.6	$1.36	3.4%	$41.47	1,872
DCT Industrial Trust (DCT)	Market Perform	$7.62	$9	$0.69	$0.63	$0.67	11.0	12.1	11.4	$0.64	8.4%	$8.90	1,308
Douglas Emmett (DEI)	Market Perform	$23.50	$23	$1.17	$1.32	$1.51	20.1	17.8	15.6	$0.75	3.2%	$26.13	2,850
Duke Realty (DRE)	Market Perform	$25.26	$25	$2.74	$2.55	$2.81	9.2	9.9	9.0	$1.92	7.6%	$29.96	3,678
EastGroup Properties (EGP)	Market Perform	$45.76	$43	$3.11	$3.27	$3.45	14.7	14.0	13.3	$2.08	4.5%	$48.45	1,139
Entertainment Properties (EPR)	Market Perform	$54.47	$46	$4.12	$4.58	$4.89	13.2	11.9	11.1	$3.04	5.6%	$50.75	1,452
Equity Lifestyle Properties (ELS)	Market Perform	$50.63	$51	$3.05	$3.21	$3.47	16.6	15.8	14.6	$0.80	1.6%	$50.99	1,247
Equity One (EQY)	Underperform	$21.06	$16	$1.34	$1.37	$1.41	15.7	15.4	14.9	$1.20	5.7%	$23.75	1,559
Equity Residential (EQR)	Market Perform	$42.41	$39	$2.39	$2.51	$2.69	17.7	16.9	15.8	$1.93	4.6%	$46.67	11,472
Essex Property Trust (ESS)	Market Perform	$117.55	$120	$5.59	$6.02	$6.29	21.0	19.5	18.7	$4.08	3.5%	$116.04	3,000
Extra Space Storage (EXR)	Market Perform	$15.82	$18	$1.09	$1.17	$1.25	14.5	13.5	12.7	$1.00	6.3%	$17.60	1,051
First Industrial Realty (FR)	Outperform	$23.01	$38	$4.64	$4.75	$5.12	5.0	4.8	4.5	$2.88	12.5%	$38.23	1,019
First Potomac Realty (FPO)	Market Perform	$16.72	$18	$1.67	$1.71	$1.72	10.0	9.8	9.7	$1.36	8.1%	$21.09	409
HCP, Inc. (HCP)	Market Perform	$36.12	$35	$2.14	$2.24	$2.38	16.9	16.1	15.2	$1.82	5.0%	$33.06	8,467
Health Care REIT (HCN)	Market Perform	$51.79	$50	$3.12	$3.37	$3.57	16.6	15.4	14.5	$2.72	5.3%	$41.87	4,915
Healthcare Realty (HR)	Market Perform	$28.44	$27	$1.51	$1.57	$1.62	18.8	18.1	17.6	$1.54	5.4%	$27.16	1,443
Home Properties (HME)	Market Perform	$53.00	$49	$3.24	$3.41	$3.55	16.4	15.5	14.9	$2.64	5.0%	$54.02	1,692
Inland Real Estate (IRC)	Market Perform	$14.93	$16	$1.44	$1.47	$1.51	10.4	10.2	9.9	$0.98	6.6%	$17.03	984
Kite Realty Group (KRG)	Market Perform	$12.23	$13	$1.26	$1.25	$1.30	9.7	9.8	9.4	$0.82	6.7%	$12.41	356
Liberty Property (LRY)	Market Perform	$37.50	$37	$3.18	$3.15	$3.21	11.8	11.9	11.7	$2.50	6.7%	$37.65	3,477
Mid-America Apartment Communities (MAA)	Market Perform	$49.97	$52	$3.55	$3.72	$3.91	14.1	13.4	12.8	$2.46	4.9%	$56.06	1,374
Nationwide Health Properties (NHP)	Market Perform	$34.57	$30	$2.07	$2.18	$2.26	16.7	15.9	15.3	$1.76	5.1%	$30.48	3,346
Parkway Properties (PKY)	Underperform	$36.32	$36	$4.00	$3.83	$4.01	9.1	9.5	9.1	$2.60	7.2%	$45.02	555
PS Business Parks (PSB)	Market Perform	$53.83	$54	$4.23	$4.54	$4.65	12.7	11.9	11.6	$1.76	3.3%	$62.61	1,100
Public Storage (PSA)	Market Perform	$91.06	$75	$4.81	$5.00	$5.39	18.9	18.2	16.9	$2.00	2.2%	$75.13	15,402
Sovran Self Storage (SSS)	Market Perform	$39.48	$44	$3.38	$3.37	$3.56	11.7	11.7	11.1	$2.52	6.4%	$45.49	863
Sun Communities (SUI)	Market Perform	$19.92	$24	$2.24	$2.14	$2.89	8.9	9.3	6.9	$2.52	12.7%	$27.36	367
UDR, Inc. (UDR)	Outperform	$24.45	$26	$1.71	$1.52	$1.63	14.3	16.1	15.0	$1.32	5.4%	$27.21	3,260
U-Store-It (YSI)	Outperform	$12.56	$14	$0.84	$0.96	$1.03	15.0	13.1	12.2	$0.72	5.7%	$15.54	727
Ventas (VTR)	Outperform	$45.19	$51	$2.67	$2.79	$3.00	16.9	16.2	15.1	$2.05	4.5%	$39.33	6,253

Source: BMO Capital Markets estimates and company reports.

Important Disclosures

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