

# The Changing Definition of Core Real Estate



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**A surprising standout as the most** conversation-provoking exhibit from LaSalle’s *ISA Outlook 2024* is titled “LaSalle’s Changing Definition of Core.” The simple table, reproduced for this article, contrasts a traditional core mind-set against an emerging “new” core mind-set. The former is focused

on classic real estate metrics, such as credit quality and lease length, and flatters the property types that tend to score well against them, such as office. The latter is a more evidence-based approach focused on predictability and growth of actual cash flows, a lens that tends to favor the living sectors and niche property types and subtypes, such as medical office.

## LaSalle’s Changing Definition of Core

| Traditional Core Mind-Set   | “New” Core Mind-Set                                      |
|---|--|
| Long Leases   | Observed Long-Run Income Resilience and Growth Potential |
| Credit Tenants  | Low Sensitivity of Cash Flows to the Economic Cycle      |
| Lease Clauses That Pass Inflation on to Tenants                         | Market Conditions Pass Inflation Into Market Rents       |
| Minimal Near-Term Capex   | Predictable Long-Term Capex                              |
| Low Operational Intensity   | Established Operating Model                              |
| Gateway City Locations  | Locations With Long-Term Liquidity and Tenant Demand     |
| Traditional Sectors—Office, Retail, Industrial, Multifamily Residential | Any Sector That Offers The Above                         |

Taking a step back, the definition of *core* can be framed in various ways. It may be cast in relation to the other main “styles” of real estate investment—value-added and opportunistic—in that core is supposed to offer lower but safer and more predictable returns than either

of those. Defining this with specificity might involve formal labels and thresholds, such as maximum leverage levels and property type characterizations. Assets and portfolios on the correct side of such definitions would be considered core and those beyond them would not be.

Of course, financial theory suggests that the fundamental value of an asset should derive from the characteristics of its cash flows, not its conformance with metrics, criteria, and labels. Given that core portfolios are meant to deliver more reliable returns than non-core ones, an understanding of their sensitivity to factors such as economic growth and inflation and their vulnerability to operational challenges should be more important than how they align with some prescribed taxonomy. In this article, I take each of the classic metrics covered in the LaSalle chart and address why a change of mind-set may lead to better core portfolios.

## Lease Length

Long lease duration is a traditional hallmark of core real estate. Long leases are often prized for their predictability of income over long periods of time. They also benefit from being easy to value with a basic financial analysis toolkit. Because they involve fixed payments spread over the term of the lease, long-lease properties can be thought of as a variation on a fixed income security. Following this logic, real estate yields can be compared directly to bond yields (with adjustments such as for the risks of potentially lower liquidity and for the impact of a variable residual value after lease expiration).

This simplicity comes with a cost—long fixed leases introduce characteristics to an asset that may run at cross purposes with the objective of income stability. For example, long leases can translate into long periods of disconnection, both positive and negative, between market rents and contractual rents. These gaps can be challenging to measure and make estimating their impact on value difficult. Long leases may also introduce frictions into flows of information regarding current market conditions. Being “in the market” continuously,

as is a landlord undertaking routine leasing in a relatively short-lease sector, such as residential, should offer a timelier, on-the-ground read on market conditions than in a sector with only occasional leasing events. This is not to say that short leases are always preferable to long ones, but there is a balance to strike. For example, hotel daily “leases” make cash flow especially volatile. And short leases coupled with narrow seasonal leasing windows, for example in student housing, may create unique timing risks.

Investors should consider effective tenancy duration alongside contractual lease length. In some sectors with shorter leases, such as self-storage and segments of rented residential, tenants are stickier than their contractual lease length suggests because of high lease renewal rates. Fundamentally, investors should care about the observed, effective long-term resilience of overall asset cash flow, as well as its growth potential. Lease length is a highly imperfect stand-in for this and, in some cases, can be detrimental to it.

### **Credit Quality**

The ability of tenants to pay rent without delay or disruption is clearly a key element of core cash flows. A traditional way to assess this is through evaluations by ratings agencies. Tools such as parent company guarantees and letters of credit can be used to enhance the apparent credit quality. But investors should consider whether traditional tenant credit metrics are, at least in isolation, the right way to define “good.” To be sure, nobody wants to have “bad” tenants, but a bad tenant isn’t necessarily the opposite of a “credit tenant.”

There are assets with low-risk cash flows that do not score well by traditional credit quality measures. For example, having a roof over one’s head is a basic human need; for this reason, residential rent is likely to be one of the last expenditures a household stops paying. Further, leasing to low-credit tenants may not be an issue if there is a deep pool of tenants to quickly backfill space with limited capital expenditure.

How can this complexity be captured in investment decisions? One way is to go beyond tenant credit to incorporate other metrics to assess the sustainability of rental cash flows, such as observed rental delinquency

rates and write-off rates. The sensitivity of cash flows in a real estate sector to the economic cycle—as well as the sensitivity of a tenant’s industry to the cycle—should also be evaluated. These could give a better clue to the underlying risks to cash flows than credit ratings in isolation, given the elevated risk of rental delinquencies in periods of economic weakness.

### **Inflation and Leases**

In some parts of the world, especially Continental Europe, commercial real estate leases are structured to offer a direct, contractual link between rent and measured inflation within the term of a lease. Such inflationary lease indexation provides a degree of comfort for core investors seeking inflation protection. However, a problem arises when market rental growth for that asset is below inflation, leading to a negative reversion upon the lease’s eventual expiration. Although inflation indexation clauses are by no means a bad thing, the protection they offer can be temporary if market conditions do not keep pace. In the long run, market conditions that are tight enough so inflation passes into market rents are essential to sustained inflation protection.

### **Capital Expenditure**

In our view, investors sometimes conflate high-quality cash flows with high-quality buildings—often defined as being new-ish, possessing up-to-date aesthetics, and having modern building systems. But real estate is a capital-intensive asset class, and buildings require substantial capital to remain competitive in the long term. Market players that consider an asset physically “perfect” at the time of acquisition tend to underestimate the amount of capital required to keep it that way over the long run. Having an asset with minimal near-term capital expenditures sounds like a good thing, but more important is that capital requirements be predictable over time; investment will inevitably be needed to keep the asset well positioned.

The office sector is a special case in underwriting capex. Office capex can be especially impactful because substantial tenant improvements are often needed to get leasing done, especially in the US. This issue intersects with the earlier topic of lease length. Assets in shorter-



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leased sectors with more granular tenant rosters, such as apartments, are likely to have smoother, easier-to-predict capex requirements than longer-leased sectors with lumpy rent rolls. Major lease expirations often translate into big capex surprises that meaningfully disrupt the stability of cash flows. A predictable level of capex, spread reasonably smoothly over time, is more “core” than near-term perfection coupled with long-term uncertainty.

### **Operational Intensity**

Some investors assume operational intensity in real estate is something to be avoided—or at least priced with an additional risk premium. But operational intensity often comes with more continuous lease rollover, and as the discussion above highlights, shorter-leased properties with granular tenant bases may create cash flows that are more core than the “it’s-a-bond-with-bricks-and-dirt” archetype. Investing in more operationally intensive sectors requires a property management team with the right structure, incentives, and skill sets. But the question

should be whether a sector has an established operating model that can be implemented with transparency and measurability, not whether the sector is operational in the first place.

### **Location**

Traditionally, the largest and most prominent metro areas—called gateway markets in the US—have been prized as the best targets for core investors. But assumptions about the benefits of investing in marquee cities have been challenged by the actual experience of doing so. For example, perceived supply barriers such as bodies of water and urban density do not always correlate with a low elasticity of supply in a market. The dynamics of which metro areas are most attractive is beyond the scope of this article, but factors such as growth, a realistic assessment of supply barriers, and pricing are all important. With investors considering these factors, the range of markets considered investable for core players has rightly broadened beyond the largest metros, especially in the US and for select sectors in Europe.

## Sector

The range of property types routinely considered core has not been fixed over time nor across geographies. Longtime observers of institutional real estate investment in the US recall when rental apartments were not considered core and core portfolios consisted primarily of traditional office assets and retail centers. Portfolios concentrated in those two sectors evolved into the four major “food groups” by adding apartments and industrial, which were later joined by a range of the so-called niche or specialty sectors that exhibited especially stable cash flows. Other countries are following this same evolution but are behind the US, with core portfolios in Europe and Asia-Pacific slowly shifting away from a heavy weight to office. Although it is true that traditional sectors were more liquid than niche sectors in the past, liquidity tends to thin when the durability of cash flows is in question. Lender attitudes can lag the equity market but should eventually follow its lead.

So which property types are core? Sectors that possess many of the characteristics of the “new” core column of the chart “LaSalle’s Changing Definition of Core” deserve the core designation; equally worth consideration is reducing investment in assets that lack these characteristics. But it is understandable that defining core in a manner akin to US Supreme Court Justice Potter Stewart’s description of obscenity—“I know it when I see it”—is not practical. Having a definition of core that lends itself to objectivity is a necessary evil because it enables transparent measurement and benchmarking.

That is why NCREIF has recently undertaken a modernization of the property type labels used in the NCREIF Property Index and the sector inclusion criteria for the NCREIF Fund Index—Open End Diversified Core Equity (ODCE). Among other changes, the “apartment” designation was transformed into “residential” and now includes single-family rentals. Although the limits on “other” property types and niche subtypes of traditional sectors in an ODCE fund have been loosened, they need to continue to evolve as real estate investors recognize the increasing broadening of core. Exercises such as these are critical to help the industry adapt and modernize and should be revisited frequently as core portfolios continue to evolve.

## What the New Definition Means for Strategy

The changing definition of core both reflects how our industry is changing and points to specific, actionable implications for investment strategy. The broadening of what is core real estate makes deciding which portion of the universe to focus on more challenging. It requires creating a disciplined approach to understanding the interaction between market pricing and fundamentals to determine where investors can find the best value.

Value-added investors should think about creating, through development or repositioning, properties that are well suited to be considered attractive by the next generation of core investors. Core investors are best served to build portfolios weighted toward assets with long-term, defensive cash flows with growth potential, not those that fit outmoded, traditional standards for core. The power of diversification still matters: strong portfolios are likely to benefit from having a mix of both new core and, selectively, traditional core assets. But for new core, diversification can be sought not only among assets but also within them. Having granular rent rolls with evenly spread lease expirations means that any single leasing decision or moment in time is not that impactful on an overall outcome—and that is a good thing. ■

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