Privately Traded Real Estate Equity

An attractive opportunity, but not without risk.

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As explained in Hudson-Wilson, Fabozzi, and Gordon [2003], the definition of real estate for institutional investors as including four market sectors (or quadrants): 1) private commercial real estate equity, held as individual assets or in commingled vehicles; 2) private commercial real estate debt, held as either directly issued whole loans or commercial mortgages held in funds or commingled vehicles; 3) public real estate equity structured as real estate investment trusts or real estate operating companies; and 4) public commercial real estate debt structured as commercial mortgage-backed securities (CMBS).

Here we discuss investing in privately traded real estate equity.

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SIZE AND PROPERTIES

It is difficult to assess the size of the U.S. private real estate equity market as there are so many ways to invest in real estate privately. There are also types of real estate, like marinas, golf courses, senior housing, hospitals and the like, that some include as a part of the investable universe and others do not. Best estimates according to a Property & Portfolio Research study published in mid-2005 are that the unleveraged mainstream portions of the private real estate equity market amount to $763 billion, representing 24% of the real estate capital market.

With no complete, let alone investable, index of private equity, there is no way to compare allocations to the market. A primary issue facing investors right off the bat is that private real estate equity is highly idiosyncratic and very difficult to access by smaller institutional investors or mere mortals.

The mainstream property types considered core or baseline in a well-designed real estate portfolio are office, retail, apartment, and warehouse properties. Their shares of the market as of mid-2005 are reported in Exhibit 1.

These four property classes can be further divided into categories such as suburban office, strip center retail, mall retail, lifestyle center retail, pad retail, community center retail, townhouse apartments, high-rise apartments, major warehouse, secondary warehouse, manufacturing warehouse, and office showroom, as examples. The geographic distinctions are nearly as rich, with primary, secondary, and tertiary urban areas, central business district, suburban, ex-urban, and resort locations.

Each property type and location and each combination has different risks, returns, and drivers as evident in the correlation matrix in Exhibit 2. The National Council of Real Estate Investment Fiduciaries Property Index, a common index of real estate performance, shows, for example, an 88% correlation between office and industrial performance since 1978 (as measured by total return).[1]

Within the sectors, there is only a 59% correlation between central business district office and industrial R&D space and only a 59% correlation between CBD and suburban office space. Clearly, there are opportunities to enhance risk-adjusted returns by wisely choosing and combining investment markets, submarkets, property types, and subclasses.

Add the various stages of development and ways to participate in it—from land banking, land development, presales, infrastructure development, merchant building, construction, to leasing, operations, and sales—and there are many ways to play and many risk profiles to assume within this quadrant. Compare this to public equity, where there is far less variety in investment activity.

There are also many ways to finance portfolio creation and expansion in the private equity quadrant. Typically an investment manager will raise capital either from a community of friends and family, family offices, endowments and foundations, or large institutions such as pension funds and insurance companies, and will execute the investment plan using that capital combined with a little, or a lot of, leverage.

Strategies can also be set around investing in assets or investing in operating entities, investing for cash flow or investing for yield (internal rates of return) and multiples, and investing domestically or investing globally.

These are no hard-and-fast rules under which investments will be made or how the relationships among the parties are governed. The private market dictates the structures, fees, governance, and rules for the allocation of proceeds. The terms of each relationship are privately negotiated among parties that have different levels of market knowledge and different senses of urgency and priority.

STRATEGIES FOR PRIVATE REAL ESTATE EQUITY

Given all this, is there a way to organize the wide range of possibilities into broad categories? There are three main categories of strategy within private equity—core, value-added, and opportunistic.

At the lower end of the risk and return scale are what are deemed core properties. These are well-positioned real estate properties with high occupancy rates and stable cash flows. Capital gain is secondary to income generation. At the opposite end of the spectrum are assets with low or unreliable income streams but with great potential for appreciation. Assets with a mixture of characteristics lie between the two extremes.

Core Strategy

A *core strategy* lies at the low end of the risk-return spectrum, and derives the bulk of its performance from cash flows rather than appreciation. Core strategies generally apply within very large portfolios of $1 billion and much more. These strategies frequently use the mathematics of portfolio theory to mitigate risk and to select and adjust allocations to markets and property types.

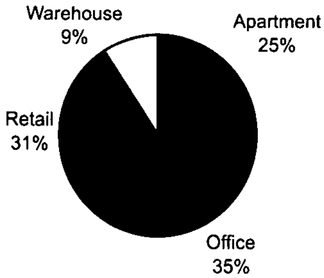
Core strategies typically assume a long-term place in an investor's portfolio.

Value-Added Strategy

As the name implies, *value-added strategies* call for the investor to bring some expertise to the real estate. These properties are a bit more aggressive in their risk profile, including the amount of leverage they use. These could be new buildings or shopping centers that are not fully leased yet. They could also be properties that need repositioning like a standing shopping mall that needs a facelift, new tenants, or a new marketing campaign. These properties tend to offer capital appreciation and income generation in equal proportion.

The investor raises a pool of capital, from the sources listed above, and buys, often using leverage and generally at

EXHIBIT 1
Private Equity by Mainstream Property Type



Source: Property & Portfolio Research, Inc.

a higher level than for a core strategy, seeking problem assets. Each asset will require some effort beyond the usual management and leasing activities. Thus a value-added strategy, unlike a core strategy, is a finite life concept. Picking the right start date and setting the absolute sell date in advance are troublesome aspects in these finite strategies.

Value-added strategies generally do not use portfolio allocation tools to mitigate market and property-type exposure risk. These strategies tend to be focused on a particular geography or property type. The investor might be experienced at converting apartments to condominiums or racetracks to large-scale mixed use properties. Or an investment may be as basic as buying from undercapitalized owners of properties, performing the necessary deferred maintenance, leasing them up, and selling them.

Opportunistic Strategy

An *opportunistic strategy* is an extreme form of a value-added strategy. It often involves very large transactions that only the really big players with access and sophisticated expertise can consider. These properties might include distressed properties or distressed sellers, commingled real estate pools much like a private equity fund, international investments, and emerging property sectors like senior housing or active adult communities. Here, current income is secondary to capital gain; appreciated value is favored above tenant income. This is the least liquid part of the real estate market.

An opportunistic strategy generally entails lots of complexity in the form of capital structure, such as private corporate ownership whose value the corporation would like to release to the balance sheet, foreign assets with government involvement, infrastructure projects, and purchases of entire banks in order to get at a bad loan portfolio. In recent times, these transactions have often come from Europe, where real estate is rapidly becoming privatized and moved off corporate balance sheets and out of public control, and from Asia, where bad loan portfolios are now offered for sale. Recent offerings include a German housing fund and a Mexican housing fund.

Opportunistic strategies will appeal to institutional investors with truly a long-term investment horizon. As overall real estate returns have declined in recent years, large institutional investors have turned to opportunity strategies to increase the returns associated with their real estate portfolios. Opportunistic investments offer double-digit returns, in the high teens and even over 20%. In a return environment of single-digit returns for public equity and bonds, these strategies begin to look very attractive.

Such investments will be most beneficial to a pension fund with a young work force and favorable demographics (where the crossover point of cash outflow exceeding cash inflow is several years away). This will allow a pension fund to generate favorable long-term capital gains when it does not need current income. This profile might also appeal to an endowment that does not foresee capital expenditures for several years.

Although precise estimates of the growth of this segment of the market are difficult to peg, one recent report puts the total at about $125 billion.[2] Whatever the precise estimate, it is clear that investment in opportunistic strategies has grown tremendously from just a few billion dollars in 2000 to well over $100 billion today.

Leverage is typically used at quite a high level in opportunistic strategies. The capital structure of these investments is generally very complex. Risks in terms of environmental concerns, currency, market turnarounds, and tenant exposure are usually high. These investment strategies are hard to access and hard to execute, and usually genuinely risky as well.

As investors all over the world either add real estate to their portfolios for the first time, or increase their allocations in a search for better performance, capital flows to real estate have been very strong. A new strategy we might call "capital surfing" has emerged since 2000. A capital surfing strategy prefers assets that will eventually be attractive to the future flow of capital. The investor simply stays one step in front of the capital flows, which are getting stronger.

As long as the favorable capital flows continue, this strategy works well and can be a fast way to earn a high IRR with little actual asset-level work required.

EXHIBIT 2
Correlations among NCREIF Property Types

	Apartment	Garden-type Projects	High-rise Elevator Projects	Low-rise Projects	Hotel	Industrial	Research and Development	Flex Space	Warehouse	Office	CBD	Suburban	Retail	Community Center	Neighborhood Center	Power Center	Regional Center	Super-Regional Center
Apartment	**1.00**																	
Garden-type Projects	0.96	1.00																
High-rise Elevator Projects	0.86	0.73	1.00															
Low-rise Projects	0.61	0.61	0.34	1.00														
Hotel	**0.45**	**0.40**	**0.60**	**0.67**	**1.00**													
Industrial	**0.79**	**0.79**	**0.93**	**0.67**	**0.52**	**1.00**												
Research and Development	0.64	0.71	0.93	0.51	0.63	0.89	1.00											
Flex Space	0.91	0.84	0.91	0.51	0.53	0.95	0.92	1.00										
Warehouse	0.77	0.77	0.90	0.74	0.45	0.98	0.80	0.92	1.00									
Office	**0.79**	**0.80**	**0.94**	**0.55**	**0.57**	**0.95**	**0.90**	**0.94**	**0.91**	**1.00**								
CBD	0.74	0.82	0.93	0.34	0.42	0.89	0.81	0.95	0.85	0.96	1.00							
Suburban	0.78	0.76	0.93	0.64	0.68	0.94	0.91	0.90	0.89	0.97	0.86	1.00						
Retail	**0.40**	**0.57**	**0.45**	**(0.16)**	**(0.01)**	**0.56**	**0.39**	**0.55**	**0.57**	**0.50**	**0.57**	**0.39**	**1.00**					
Community Center	0.46	0.66	0.57	(0.25)	0.10	0.62	0.47	0.65	0.61	0.57	0.59	0.49	0.95	1.00				
Neighborhood Center	0.63	0.72	0.62	(0.17)	0.25	0.71	0.55	0.67	0.70	0.74	0.74	0.68	0.81	0.87	1.00			
Power Center	(0.22)	(0.18)	(0.39)	(0.14)	(0.28)	(0.49)	(0.50)	(0.52)	(0.43)	(0.38)	(0.22)	(0.45)	0.90	0.83	0.74	1.00		
Regional Center	0.51	0.60	0.43	(0.12)	0.05	0.56	0.39	0.54	0.57	0.53	0.66	0.40	0.97	0.92	0.85	0.92	1.00	
Super-Regional Center	0.42	0.43	0.33	(0.1)	(0.11)	0.46	0.27	0.43	0.50	0.40	0.55	0.25	0.97	0.88	0.70	0.92	0.91	1.00

Source: NCREIF; Property & Portfolio Research, Inc.

VALUATION

One significant problem in the private equity quadrant is valuation. As the market is by definition private, transaction and carrying values do not have to be disclosed to anyone except the investors themselves and sometimes, depending upon the rules of engagement, not even to them.

Investors work hard to discover transaction values. Even when one is an insider in a private portfolio, at best the valuation is known when the asset is acquired and then as it is marked to market (if it is marked to market) annually or even less frequently. Appraisers try to assign an interim value to an asset, and while, over time, these valuation exercises have certainly improved, there is no guarantee that they are correct.

Unfortunately, in the private market there are infrequent chances to revisit what may be an incorrect valuation. Thus, until an asset is sold, the investor really does not know its value. For closed-end portfolios of value-added and opportunistic strategies, the question of interim valuation is much less of an issue, as an investor's capital is locked up until the fund is liquidated in any event. Assets in such portfolios are even more difficult to value, given their complexity and risk profiles.

Valuations can also be subject to selection bias, because the properties changing hands may not be indicative of the underlying market. In cyclical downturns, valuations may remain comparatively high due to selection bias, as buyers' offer prices drop while sellers' ask prices do not, leading to fewer transactions. There are ways to correct for selection bias, which is an issue for any investor or manager attempting to outperform a benchmark such as the NCREIF Property Index.

Valuation problems are particularly an issue for any strategy that is open-ended, or that allows for new investments and withdrawals over time. One very large mutual fund company as of early 2005 was preparing to launch a significant new private REIT that will allow for quarterly additions and withdrawals. It will be interesting to see how this provides investors an assurance that the valuation process will be fair and true. If this firm is able to successfully crack this nut, individual investors' access to private real estate will improve dramatically. This is an experiment to watch closely.

CONCLUSION

The quest for yield is under way in every asset class. With rising interest rates eroding bond portfolios, and lower stock returns expected, institutional investors are searching for new venues to generate return. Private equity real estate is a demonstration of this search for yield.

While the total returns for private equity real estate are attractive—high teens and even low twenties—they are not without risk. Private equity real estate, especially in a commingled vehicle, is one of the least liquid asset classes, on a par with private equity limited partnerships. Further, these investments are highly idiosyncratic; they can represent investments as varied as a German housing fund and a Chinese apartment fund.

Finally, many of the non-core investments generate very little in cash flow in the early years of investing, so a substantial return premium above traditional core real estate returns is required to attract capital to these investments. For investors with long time horizons, such as public and corporate pension plans, private equity real estate presents an attractive opportunity.

ENDNOTES

[1]The NCREIF Property Index is published by the *National Council of Real Estate Investment Fiduciaries* (www.ncreif.com).

[2]See Fruchbom [2005].

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