Is There Value in the Private Real Estate Marketplace?

AUGUST 2008

Recently an investor asked if it was better to own real estate directly (the private market) or publicly (in the form of REIT stocks). The answer to this question is a little complex and actually has a third alternative, the private "non-traded" REIT market.

This is a review of the pros and cons of each of these "income-producing" commercial real estate sectors and does *not* address single family homes.

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Private Market Real Estate

Owning a real estate property is essentially like owning a business. There are clients — the tenants — who pay for the use of the space and the services that the landlord might provide including cleaning, upkeep, maintenance, snow removal, utilities and property taxes — just to name a few things. Real estate management is a professional business with many highly trained and competent people who handle marketing, leasing, property management, sales and other vital duties necessary to run the property. Many small investors try to handle all these duties by themselves and some are successful while others are not. To do it right, it is usually a full-time job that requires talent, education, dedication and good business skills. Most universities now have a real estate major in their business school programs and even graduate degrees in real estate as there is strong demand for professionals in the commercial real estate marketplace.

The challenge is that most investors cannot afford to buy large real estate properties worth millions of dollars, as they must be purchased in whole, which requires a large amount of cash all at once and a very complex and expensive sale and closing process. Purchasing a single property is like buying a private business that is subject to the local marketplace. Thus there is no diversification and lots of concentration risk in a single real estate asset purchase. Building a new property from the ground up adds development risk to the picture and should definitely be left up to the development professionals.

Institutional investors believe that real estate is a separate asset class and make investment allocations from their overall portfolio to real estate — typically between 5% and 20% of their overall portfolio. But they are large enough to be able to hire professional investment managers to invest their money or allocate money to diversified institutional real estate investment funds that usually have minimum level investments of $20 million or more. There is one opportunity for individual investors to invest in a large diversified "direct" institutional real estate fund and that is with TIAA-CREF, the largest private pension investment advisory firm in the United States that focuses on teachers. This fund is similar to institutional funds and can only be redeemed quarterly after the appraisals are done — so there is less liquidity than the public markets.

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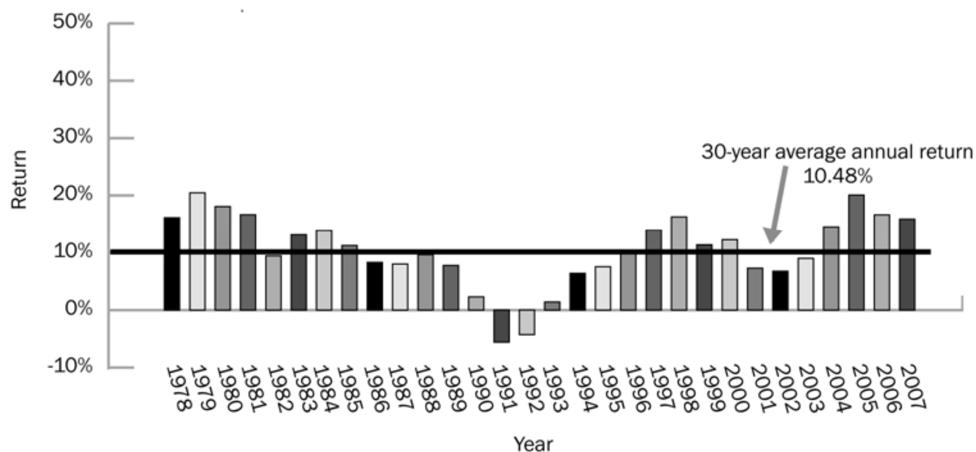
Returns on private real estate are hard to determine because the private market does not report prices or income in any public format. To overcome this challenge, institutional investors got together in the mid 1970s and formed a group called the National Council of Real Estate Investment Fiduciaries (NCREIF).

The major purpose of this organization has been to collect investment performance data on private real estate investments held by its institutional investor members — mainly pension funds and endowment funds such as California Public Employees Retirement System (CALPERS) or the Yale University Endowment Fund.

The NCREIF Property Index is now widely known and accepted as the best example of private long-term real estate investment returns. However, the NCREIF index composition must be understood. The individual buildings in the index are large institutional buildings known as "core real estate," which includes large office buildings, warehouses, retail centers, apartments and hotels, and which are mostly in the top 20 largest cities in the United States. These properties were purchased for their high-quality income resulting from creditworthy tenants, long-term stable leases and first-class locations. The prices paid were normally full market value and the returns more "bond-like" in nature (moderate value increases with moderate "bond-like" yield). The returns are composed of the net income produced by the buildings, plus any price appreciation or depreciation as determined by an appraisal on the property — since the properties are not bought and sold on a regular basis. The returns are also reported as though the buildings were purchased with all cash, as loans (or leverage) are a separate investment decision that can have different consequences depending upon the investor and their risk profile.

Since its inception in 1978 through December 2007, the NCREIF Property Index has produced an average 30-year return of 10.48% with a standard deviation of 6.23%. This includes two years of negative total return. With leverage, the return to equity would be higher, but the return volatility (the risk) would also increase. NCREIF really represents the returns of low-liquidity, large institutional-quality private real estate. The biggest criticism of the NCREIF index is that the price appreciation comes from appraisals, so the returns are smoother than publicly traded investments. But that is part of the point. There is a choice between having lower liquidity with less price volatility and more liquidity with higher volatility. In a diversified portfolio of stocks, bonds and real estate, is it necessary to have full liquidity in all investments? Or is there room with a long-term investment horizon for some stable — but less liquid — long-term investments?

NCRIEF Property Index Annual Returns
(1978 – 2007)

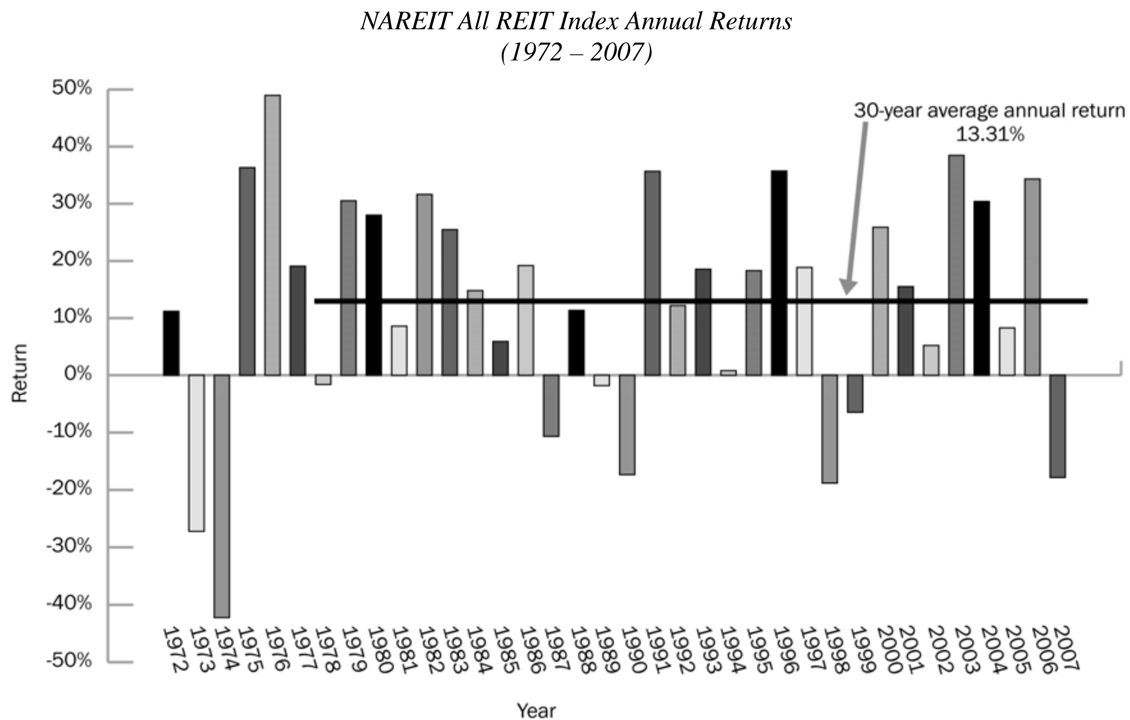


Source: NCREIF

Public Real Estate

In 1960, the U.S. government passed legislation allowing the formation of real estate investment trusts (REITs) so that the small investor could invest in large commercial real estate. The REIT vehicle is just like a mutual fund where a large group of investors pool their money together into a fund with a professional manager who buys and manages many investments. (Stocks are purchased in a mutual fund and real estate properties in a REIT). The REIT industry formed its own organization, the National Association of Real Estate Investment Trusts (NAREIT) and began monitoring performance by creating the NAREIT index in 1972. The NAREIT All REIT Index has produced a return of 12.59% since its inception in 1972 through December 2007, with a standard deviation of 20.62%, but nine years of negative returns. For an equal comparison to NCREIF, the 30-year return is 13.31% with a standard deviation of 16.96% with seven years of negative returns. While the NAREIT returns look better by more than 2% over direct real estate, the standard deviation is much higher and has the potential for an actual loss in some years (there were two years of actual negative total returns in the NCREIF index).

NAREIT All REIT Index Annual Returns
(1972 – 2007)



Source: NAREIT

Publicly traded NAREIT returns are different from the NCREIF private real estate returns as they include the use of debt (leverage which increases risk, but also increases returns to equity) and management's ability to sell properties and reinvest proceeds into new properties that are more promising. Thus the investor gets real estate, capital structure and management's efforts in the total return of a REIT. The other REIT benefit is the liquidity of a publicly traded stock which is paired with the challenge of the price volatility in REIT returns. Most REITs invest in one of the major property types so a mixture of REIT stock purchases are necessary to diversify by property type and city within the real estate area, but there are also many REIT funds available, both actively managed and passively indexed.

Can we compare apples to apples?

So is there a way to compare private real estate investments to public investments? A general comparison of the NCREIF private real estate index to the NAREIT public index over 30 years finds a low correlation in returns of only .026. The problem is that this long-term correlation is an apples to oranges comparison in a number of ways. As stated earlier, NCREIF is unleveraged while NAREIT is leveraged and actively managed. The NCREIF index is also an "exclusionary index" that removes a property once it has been sold and does not consider reinvestment of the original investment or profit. REITs on the other hand can "recycle" capital by

selling a property and reinvesting both the original investment and profit into a new property that supposedly has a higher total return potential. Thus REIT returns include not only property appreciation and income, but also the benefits of financial leverage and active portfolio management. In addition, the historic property type compositions of NCREIF and NAREIT are quite different. As recently as 1990 the NCREIF index was 40% office with very little apartment, while the NAREIT index was 40% apartment and 40% retail with little office.

In September 2003, Dr. Joseph Pagliari from Northwestern University published a paper in *The Journal of Portfolio Management* titled "Public versus Private Real Estate Equities, A Risk Return Comparison." He wisely "de-leveraged" the NAREIT index to compare it to the unleveraged NCREIF index and also decomposed both indexes by property type to compare property type returns. His findings show that both the public and private real estate index returns have been similar over time when property type composition and leverage are the same. Thus an apples to apples comparison shows that public and private real estate returns are similar over time, but leverage, property type and management matter.

Non-Traded REITs — A Third Option

When the REIT concept was created in 1960, they were not required to be publicly traded, thus the REIT vehicle has been used in a private context for both individual and institutional investors. One popular option is the non-traded REIT. A non-traded REIT sells shares at a set price to investors over a specified offering period. During this offering period, the REIT is not traded and investors receive a stated dividend set by the REIT's Board of Directors. The public market sets a traded REIT's price based upon the market's opinion of future revenue growth. (This is the standard Gordon's Dividend Discount Model taught in every stock valuation class in the country — better known as the Dividend Discount Model). Thus public REITs have traded above and below their "estimated" private market value, usually called Net Asset Value (NAV) with a range of 20% premiums to 30% discounts, but with an average 7% average premium. Why? Because there is *value* in management and capital structure as discussed earlier. If other companies and industries on the stock market sold at their private market liquidation value, stocks would decline about 70% in price today!

Non-traded REITs eventually have a "liquidity event" that is planned but not guaranteed, which might be the public listing of the stock, sale of the entire portfolio to a large investor or sale of individual buildings. At the time of this event, the portfolio will be "marked to market" and the investors will have the opportunity to capture price appreciation or accept a price decline. While the actual private market value of the underlying properties (NAV) may fluctuate during the non-traded period, the REIT sponsor absorbs that volatility — just like most private funds. Most sponsors of non-traded REITs offer a limited "share redemption program" on a variable scale — starting as low as 90% redemption in year one and rising to 100% in year four. Thus investors should receive a stable dividend plus their money back after four years of holding the investment — less liquidity than publicly traded REITs but no market volatility.

Therefore, over a long-term holding period and assuming a liquidity event, investors in non-traded REITs should receive returns that are somewhere within the range of private real estate and public REITs as they are investing in real estate assets with management and capital structure similar to public REITs. It is just that during the beginning of the holding period, the investors give up liquidity in return for no market volatility, with the ability to receive principal back after four years. However, the investor only receives price appreciation if they hold until the liquidity event of the private REIT, which could be as long as 10 or more years away. Thus the investor must count on the management and investment expertise of the non-traded REIT manager to enhance value over a long holding period and select the right time for a liquidity event. This is similar to the faith that an investor puts in a manager when he/she buys a mutual fund. He or she is trusting the mutual fund's portfolio/investment manager to time purchases and sales to maximize returns. REITs have been characterized as mutual funds of real estate as they work just like mutual funds (many investors pool their money with a professional manager who makes individual investment and disposition decisions). So the non-traded REIT is a hybrid of private and public investing.

Sponsor Reliance

There is no question that the sponsor of the non-traded REIT is a key ingredient in this investment. The sponsor must be able to pay the dividend, make redemptions at stated prices when requested and eventually effect a liquidity event. The timing of the liquidity event is key and real estate has historically gone through cycles that would allow any sponsor to time a liquidity event during the 10-year typical life of a non-traded REIT. Investors must only accept the illiquid nature of the investment until the sponsor decides to liquidate. Many institutional investors have increased their allocations to real estate and other "alternative investments" to provide better long-term returns and have given up current liquidity in exchange for good long-term returns.

Conclusions

- Investors should have a long-term perspective to invest in commercial real estate
- Profit comes from appreciation, but timing of a liquidity event is important
- Sacrificing liquidity for stability is less nerve-wracking for many investors and advisors

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