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Core Private Real Estate

Perhaps unique among the world's major asset classes, real estate is more likely to have a private owner than an exchange listing. As a result, the universe of investable assets, for most portfolios, is regrettably light on real estate. Versus Capital, a manager of private real estate funds, cites figures putting the total size of the global real estate market at $50 trillion (the equivalent figures for equities and fixed income are $63 and $99 trillion, respectively). Only $3 trillion of the $50 is publicly traded, however.

Why would property owners pass on the IPO option that has transferred so many companies, especially in the United States, into public hands? The first part of the answer is that many have gone public in the past quarter century. A 1960 act of Congress created a corporate structure, the real estate investment trust (REIT), that made it tax efficient to bundle a group of properties in one publicly traded entity with professional management. This concept took off in 1993 (most of the data we cite will begin in that year). The number of REITs doubled in three years (to 178) and total market capitalization nearly quintupled (to $50 billion). As of 2013, the market capitalization of US REITs stood at $600 billion according to NAREIT.

The bulk of the answer, however, is that most real estate owners count the costs of public markets greater than the benefits. Mark to market pricing, if done efficiently, is a positive for investors. However, we discuss later how often and wide the REIT market misses. Private real estate owners might prefer the quarterly liquidity of a vehicle that prices at appraised net asset value (NAV) over the minute-by-minute liquidity of a REIT that bakes in undulating market sentiment. This month's *Bulletin* explores this and other differences between the public and private sectors.

Before we get started, a quick note on the type of private real estate we plan to cover. The market is loosely divided into a few categories. Our data refers to the core and core-plus segments, or leased buildings requiring few improvements located in large urban areas. Other categories of real estate – value-add and opportunistic – require more sweat equity, may be less prominently located, and are usually owned in locked-up structures (e.g. ten years). These types of properties usually carry more debt. There are reasons to consider all types, but the scope is too large for this paper.

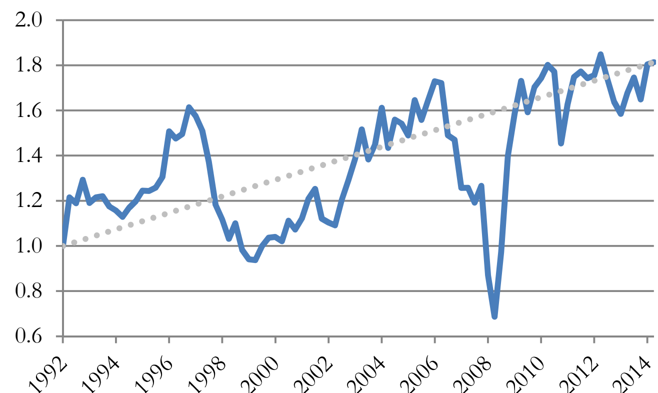
NAV Pricing > Market Pricing

NAV pricing for a real estate investment means that an appraiser runs a process to compare a building to its peers in the same area and derives a value. The appraisal values for all properties in a portfolio are totaled up to compute an NAV for the fund. A market price, by contrast, is determined only by negotiation between actual buyers and sellers. Market and NAV should be similar in an efficient market, but can differ wildly in times of exuberance or stress.

The "greater than" symbol in our section header denotes desirability. For those hoping to allocate a portion of their portfolio to pure real estate fundamentals – a series of (hopefully growing) rents – the public markets can be a distortion. This is evident in the standard deviation of public real estate returns. Since REITs gained traction in 1993, the aggregate standard deviation (as measured by the FTSE NAREIT Index) of their returns has been 20% compared to 6% for the private NCREIF ODCE Index.

Figure 1 is an imperfect attempt to depict the gyrations. If the public market did a fair job valuing real estate fundamentals, you would expect the ratio of the NAREIT and ODCE indexes to loosely follow the dotted grey line. If you assume the graph starts and ends at a time when REIT prices equaled NAV, and that the cumulative income generated in between by the public and private indices was equivalent (three big ifs), then any time the blue line is above the dotted grey line the REIT market is priced at a premium to NAV. Any readings south of the grey line indicate an embedded discount. This imperfect picture is broadly similar to what we see from independent third party evaluators of real estate NAVs.

Figure 1: The Price of REIT Liquidity
Ratio of FTSE NAREIT to NCREIF ODCE
Sources: Bloomberg, NCREIF



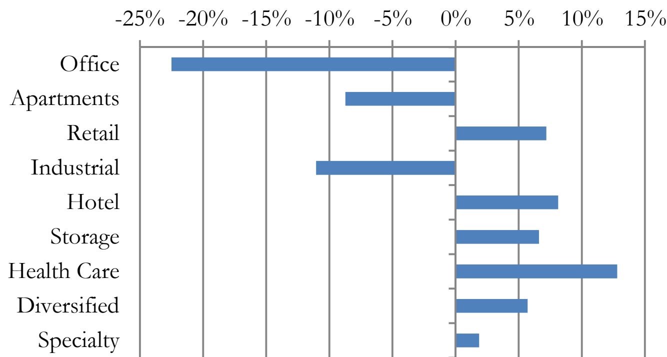
Structure of the Core Private Real Estate World

If you look beyond pricing, you find more dissimilarity between the private and public real estate worlds. Capital structures are different. Properties held by managers in the NCREIF ODCE Index currently utilize 23% leverage, or $1 of borrowed money for every $3 dol-

lars of equity. Per Versus Capital, REITs tend to use more, usually 40 to 60%. An equally weighted average of a broad group of REITs we reviewed currently works out to 43% debt as a percentage of assets.

The types of property owned by a typical private manager can differ from those owned by a REIT. Figure 2 summarizes the relative weighting by real estate sector in the public versus private arenas. A positive figure indicates an overweight within REITs versus private; a negative number means a REIT underweight.

Figure 2: Sector Differences
Wilshire US Resi Index minus NCREIF ODCE Index
Source: Versus Capital



REITs are overweight types of properties with more volatile cash flows. Hotels, for instance, source one night leases. Storage facilities are looking for new customers probably every month or so. These types of businesses are well positioned to capture spikes in demand, but also exposed to a sudden evaporation. The certainty of profits in these kinds of sectors is lower.

By contrast, core private real estate managers own more offices, apartments, and industrial complexes. All of these properties sign their tenants up for one year (apartments) or more (over five years on average for office). These businesses are steadier: less likely to catch a surge in demand, but likely to do better when it dries up.

Interest Rate Sensitivity

Private real estate tends to be less sensitive to rising rates. Versus Capital has found that in the six periods since 1993 during which the ten year US Treasury yield moved 1% higher core private real estate earned 14.1% on average and no worse than 6.8% during the 1993-94 tightening. REITs posted 13.0% during these same cycles, but with much greater dispersion: two periods of rate tightening heaped losses on REITs (1993-94: -5.2% and 1999: -6.5%). The discussion in the previous section likely holds the explanation for this difference. Higher leverage and more volatile business segments can combine for trouble as borrowing costs increase.

What is the Case for REITs?

There are still reasons to own REITs. First, they have outperformed their private brethren handily since the beginning of 1993. We calculate a result 2.9% better (annualized 11.5% vs. 8.6%). This is a conservative calculation – both indexes are gross of what you would need to pay a manager to (hopefully) deliver such a return, and it is a safe bet that it would cost more to hire a private manager. REITs can be expensive if accessed through an active manager but can alternatively be purchased for just 0.12% at Vanguard.

Further, REITs are more accessible, less burdensome to own in terms of reporting and tax filing, and easily liquidated. We believe there is a reward for foregoing all of these characteristics on the private side, but this is not a certainty, and therefore a position in both can make sense.

This paper has looked at the differences within the real estate world. It is worth discussing the prospects for real estate relative to other asset classes as well. As is the case with many assets today, prices have run up and now appear expensive on an absolute basis. We hear from managers that cap rates, or the current yield, on high quality properties range from 5 to 6%. That is below yields paid historically, and suggests real estate will have trouble earning more than 10% on average going forward. Compared to bonds, however, real estate is more attractive. Typically cap rates are about 1.5% higher than the ten year US Treasury whereas today there is about a 3% additional reward for the property owner.

The Keel Point Investment Team is working on some opportunities in the private real estate space to complement what we already do there and in REIT world. On the basis of the differences outlined here, we think this will be a value add for client portfolios. □

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