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Potentially Higher Returns await in Middle Market Private REITs

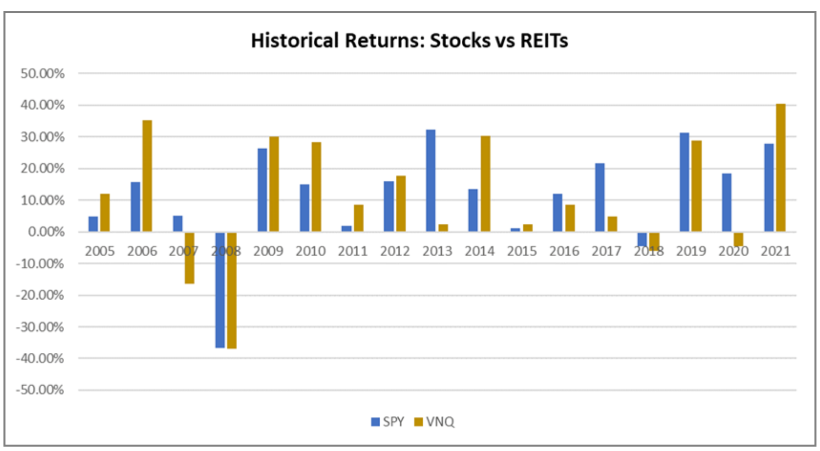
Introduction to Investing in Commercial Real Estate

For years investing in commercial real estate was the advantage of very wealthy, and an option only to those that had the means to structure and finance commercial properties. But the barriers to entry have come down. In 1960 Congress established Real Estate Investment Trusts structure where investors can pool funds to invest in commercial real estate through publicly traded companies. Today, there are many vehicles an investor can use to participate in the commercial real estate market through REITs (public and private), private equity funds, debt funds, mutual and close-end funds. These funds can help diversify an investor's portfolio holdings between different sectors, such as multi family, industrial/warehouse, hospitality, resorts/entertainment, retail, office space and alternative. Some REITs however, instead of diversifying, invest in concentrated sectors or geographical areas.

Are the advantages of lower correlation for private REITS large enough to overcome the advantage of liquidity held by publicly traded REITS?

The purpose of this article is to discuss the salient points of real estate investing and touch upon the difference between public versus private offerings. When we think of commercial real estate investing, the REIT structure comes to mind. This allows an investor of any level to buy shares in corporations or trusts that own real estate and directly participate in the profits and losses from a portfolio of the underlying commercial properties. REITs by law are required to pay out 90% of their taxable profits in dividends to maintain their REIT status. By design, REITs tend to represent large commercial properties that are stable, while rents and depreciation make up the majority of returns to investors. Public REITs tend to use less leverage than the private funds (Public: 30 to 50% of property value versus Private: 60 to 80% of property value). The main reason public REITs tend to use less leverage is due to the nature of expected duration. Public REITs are considered perpetual versus private REITs that in general have a 3-to-7-year exit- strategy. Targeted dividends for publicly traded REITs are in the area of 2 to 6%. There are opportunities for moderate capital appreciation on public REIT properties. The main advantage of public REITs is increased liquidity. A large disadvantage of public REITs is the high correlation to the stock market and the associated volatility. Privately traded REITs have low correlation to the stock market because they are valued by periodic appraisals which tend to smooth out the NAV of the private REIT.

Investors find that commercial real estate has several advantages. First, real estate is often thought of as a diversifying tool to complement a portfolio of stocks and bonds. (In general, over the last 20 years, Publicly traded REITs have a 70% correlation to stocks and 13% to investment grade bonds). In our current environment with low bond yields, worldwide investors have used REITs as bond alternatives to make up for the low interest payments by bonds. REIT dividends are not fixed like bond interest payments and possibly not as safe as bond coupon payments over a full economic cycle. Inflation has become a topic again and commercial real estate has historically done well in inflationary times. Historically, both rents and real estate values tend to increase along with broader price levels, providing real estate owners with higher nominal revenues.



- Refer to disclosures page on www.WarrenFinancial.com for details on the calculations. Compound changes: (EndPrice/BeginPrice)^(1/(#days/365) -1
- All public ETF returns are calculated not using adjusted closes and thus not including dividends – if dividends had been included the numbers would be better for both the SPY and the VNQ. Returns are after ETF management fee as reported by TD Ameritrade and/or Yahoo Finance.

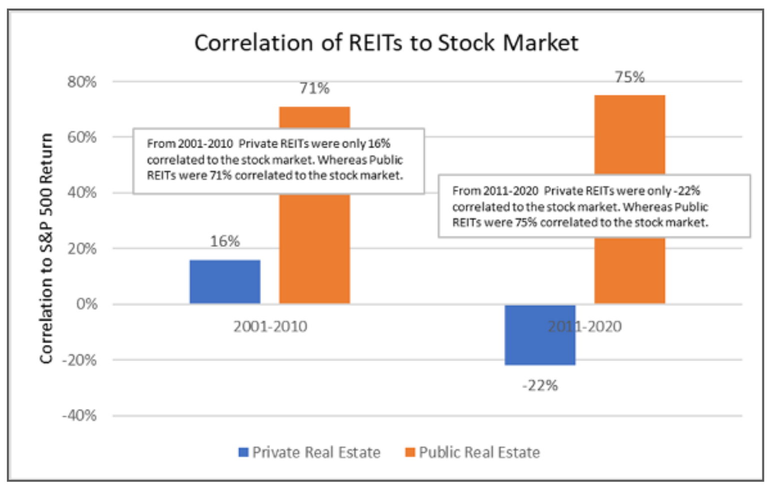
We have narrowed the focus of this article by not focusing on REITs that specialize in debt structures.

Public and private real estate had powerful performance in 2021 outperforming the S&P 500 index (as represented above by the SPY ETF and shown above compared to the VNQ ETF). Two of the largest publicly traded ETF REITs are the Vanguard Real Estate ETF (VNQ) and Real Estate Sector SPDR (XLRE). In 2021, VNQ was up 36.59% (not adjusted to include dividends, after costs) and XLRE was up 41.71% (not including dividends after costs) versus a plus 26.58% for the S&P 500 index (not including dividends, no fees)! Publicly traded REITs are usually benchmarked to the FTSE NAREIT (FNAR) while the private real estate sector is benchmarked against the NCREIF (ODCE). But due to the diverse strategies employed by private real estate investments, it is hard to lump them all together. Public listed REITs trade on the major public stock exchanges and are the most liquid form of real estate investing. The trade-off for this liquidity is increased share price volatility, especially over abbreviated time frames. During any given year, there is a high correlation between publicly traded REITs and the overall stock market. This correlation of publicly trade REITs and equities may not leave investors as diversified as they think versus private REITs and private equity real estate.

The relatively high public REIT to stock market correlation is exacerbated during sharp market pullbacks. In 2020 during the pandemic public REIT ETFs were down (VNQ at its lowest point was down -35.32% and down -7.95% for the year and XLRE was down -29.45% and down -5.04% for the year). Even on the up side, the recovery in commercial real estate has been similar to the US economy; slightly uneven as those tied to tech (data centers, cell towers, industrial and infrastructure) have risen sharply, while sectors such as hospitality, office retail health care have lagged significantly.

Benefits of Private REITs

Besides the private REIT structure, other private real estate investment structures include closed end, mutual funds, and private equity funds. Private Equity funds are structured differently than REITs or mutual and closed end funds. Private Equity funds usually are limited partnerships and investors must be accredited according to SEC rules. Both private equity and private REIT investments are passive, where you have a management team to make the decisions and effectively run the properties. Private Equity partnerships are also different from REITs in that there are fewer investors and minimum investments tend to be higher. This is an area where we see active endowment, pensions and high net worth investors because with less liquidity, returns have to be enhanced. The argument can be made that private equity funds tend to be a better diversifying tool than publicly traded REITs, as indicated by the chart#2 below.



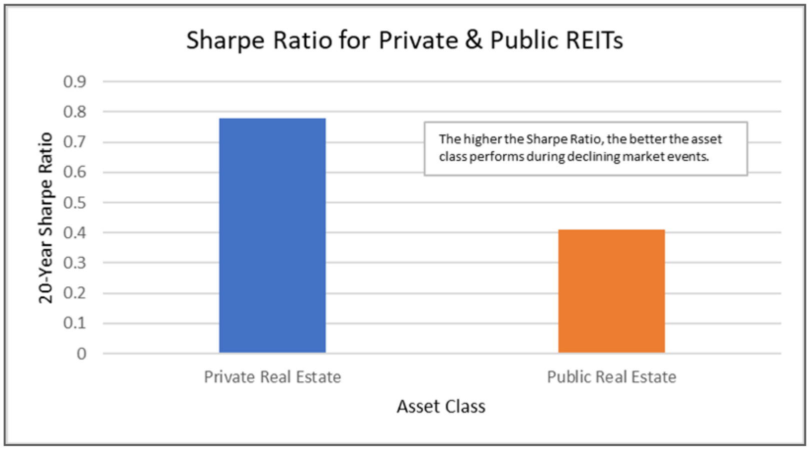
This Chart #2, demonstrates the high correlation of publicly traded REITS to the overall stock market and the relatively low correlation of privately traded REITS to the stock market.

Private Equity funds can be more flexible in their underlying investments which can be more concentrated, and their partnerships may contain fewer properties than the publicly traded REITs. Although private equity funds invest in large institutional properties that generate cash flow, they also have the option to invest in “Opportunistic” and “Value Add” projects. “Opportunistic” is a term used to describe a ground up construction project that will produce little revenue for the first 2 to 3 years. With “Value Add”, the fund will go in and upgrade/renovate existing property. The “Value Add” investment structures tend to generate less income since there may be vacancies depending on the scope of the projects. Target returns in private equity funds tend to be 12-24% which is much different than the REIT scenario with dividends and appreciation targets of 7 to 11%. In Private Equity Funds the management is using expertise in finding misprice properties, areas with high barriers to entry, and areas that are economically changing. Since it is a partnership, management invests alongside the limited partners which implies that managements’ interests are better aligned with investors’ interests.

The so-called “middle market” (usually under fifty million dollars) can provide investors with unique opportunities that would be too small for the large REITS. Because these opportunities are smaller, there are more inefficiencies and less lending dollars available. Due to their positioning, Middle Market opportunities may provide higher returns to investors. Middle Market opportunities also tend to have an exit strategy of 3 to 7 years. As each property is sold, the investors realize their returns. Also, from a tax point-of-view the returns are usually long-term capital gains. Alternatively, the REIT structure dividends are taxed as ordinary income. Investors in both REITs and Private equity have the ability to use the Qualified Business deduction on 20% of dividends in accordance with the TCJA act. from 2017.

Conclusion

In conclusion, investors can use private real estate investment opportunities to diversify their portfolio. These private investment opportunities can provide a source of cash flow and a hedge against inflation. Publicly traded REITs have the advantage of lower minimum investments and high liquidity. However, the price for this liquidity is increased near-term volatility.



This chart shows the 20-year Sharp ratio for public vs private REITs. A higher Sharp ratio indicates an investment that performs better during market downturns. Private REITs have higher Sharp ratios than Public REITs as shown in the chart above, over the time period specified.

Many experts in the real estate industry have touted that public REITs have outperformed private real estate funds, yet statistics do not show that to be the case. “Opportunistic” and “Value added” have been the best performers overall, and like Venture Capital and Private equity the performance value comes from the top quartile managers in that space. Because access to the best managers is a major consideration for pension funds and endowment funds, they have invested approximately 80% of their real estate commitment in private equity funds.

The bottom line is that if an accredited investor can handle the illiquidity of private REITS, the middle market provides some opportunities to generate abnormally large 3-7 year returns. If an investor is not accredited they can only access the public REIT market with increased liquidity, higher volatility, high equity correlations, and potentially lower long term returns with higher tax rates. Any realtor will tell you that the three most important things are (1) Location. (2) Location. (3) Location. This is certainly true for middle market, high return opportunities. It’s more about the specific opportunity, the location, and the deal parameters. Potentially higher returns await in middle market private REITs.

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