Commercial Real Estate Investment: REITs and Private Equity Real Estate Funds

September 2011

Executive Summary
The analysis presented in this paper evaluates the reported performance of commercial real estate through publicly traded equity REITs and private equity real estate funds. The actual performance records now available reveal that publicly traded equity REITs provide a significant investment return premium compared with private equity real estate funds, as well as other public market attributes of liquidity, transparency, monitoring and access to public debt and equity financing. Public equity markets are generally better informed and more efficient, with asset values responding more quickly to publicly available information. Publicly traded equity REITs have outperformed core, value-added, and opportunistic funds consistently over the long term, experienced stronger bull markets, recovered faster from downturns, and had lower fees and expenses on average compared with private equity real estate funds. This analysis supports the case for pension funds and other institutional investors having larger allocations to publicly traded equity REITs than they typically do today as part of a real estate portfolio invested in both REITs and private equity real estate funds.

Table of Contents

Introduction: The Real Estate Investment Proposition

There have been significant swings and uncertainty surrounding the performance of real estate investments for the past few years, causing individual and institutional investors alike to reassess their real estate allocations and their strategies for implementing them.

For most investors, gaining access to commercial real estate exclusively through publicly traded real estate investment trusts (REITs) is the most practical way to invest in the asset class. However, defined benefit pension plans and some other institutional investors often face a more complex opportunity set of real estate investments.

Traditionally, these investors have not looked to their real estate portfolios as a source of liquidity, and many have allocated most of their real estate investment capital to a combination of direct property investments and private equity real estate funds. Moreover, many large investors embraced commercial real estate as a distinct asset class before publicly traded REITs provided a large, liquid and transparent market alternative to direct real estate investments. Although many defined benefit plans include publicly traded REITs within their real estate investment programs, REITs generally occupy a surprisingly small portion of the total real estate portfolio.

According to the IREI/Kingsley Associates "Tax-Exempt Real Estate Investment 2010" survey of major tax-exempt investors, survey participants indicated that they planned to invest 96.5 percent of 2010 real estate allocations to private forms of debt and equity, including 74.0 percent to private equity real estate funds, but only 3.5 percent to publicly traded REITs. The marginal investment allocations to REITs by some of the nation's largest institutional investors is surprising, not only because of the strong historical investment performance of publicly traded REITs when compared with private real estate investment alternatives, but also because of the heightened focus on critical funding shortfalls and improved risk management practices in the wake of the 2008-2009 financial crisis, which highlighted the value of REIT liquidity, transparency and investor-aligned governance.

Recently available data now offer institutional investors the opportunity to compare more rigorously the reported performance of publicly traded REITs with that of private equity real estate funds. Given the performance advantages of publicly traded REITs relative to private real estate funds as well as the risk-reduction benefits of combining public and private real estate investments, institutional investors that traditionally have relied primarily on private real estate investments, such as many pension funds, should re-evaluate how they balance their total real estate allocations using both private real estate funds and publicly traded REITs.

Data Inputs for Measuring Performance

REITs

Equity REITs own, manage and lease investment-grade, income-producing commercial real estate in nearly all property sectors, including office, industrial, apartment, retail, health care, self storage, data center, hotel and timber. Equity REITs use a moderate amount of leverage, with an industry average debt ratio of 41.1 percent as of September 30, 2010. REITs have access to public equity and debt markets, having raised $37 billion in 2009 and another $43 billion in 2010.

The investment performance of publicly traded equity REITs is measured using total returns from the FTSE NAREIT All Equity REITs Index. As of April 30, 2011, the FTSE NAREIT All Equity REITs Index included 120 companies with an aggregated equity market capitalization of $393 billion.

Private Real Estate Funds

Core: The investment performance of private equity real estate funds using a *core* investment style is measured using total returns from the National Council of Real Estate Investment Fiduciaries—Open-End Diversified Core Equity Index (NFI-ODCE). A diversified *core* equity investment style typically involves lower risk equity investments in stable U.S. properties using relatively little leverage. As of September 30, 2010, the NFI-ODCE Index included 16 commingled funds totaling $76.3 billion of gross real estate assets and reported an average debt ratio of 29.6 percent.

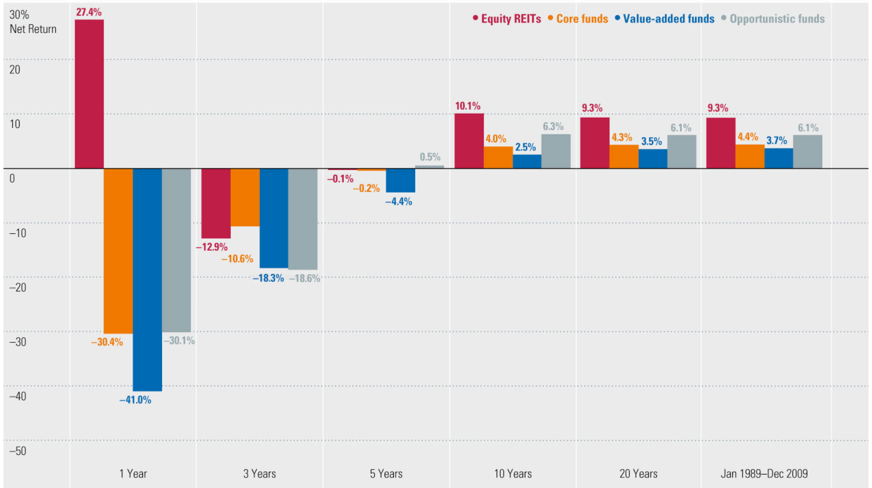
Value-added: The investment performance of private equity real estate funds using a *value-added* style is measured using total returns from an index jointly produced by NCREIF and The Townsend Group. A *value-added* investment style typically involves higher risk equity investments in U.S. and/or international properties using more leverage than core funds but less than opportunistic funds. As of June 30, 2010, the NCREIF-Townsend Value-Added Index included 79 commingled funds with $57.9 billion of gross real estate assets and reported an average debt ratio of 55.5 percent.

Opportunistic: The investment performance of private equity real estate funds using an *opportunistic* style is measured using total returns from an index jointly produced by NCREIF and The Townsend Group. An *opportunistic* investment style typically involves high risk equity investments in U.S. and/or international properties using even higher leverage. As of June 30, 2010, the NCREIF-Townsend Opportunistic Index included 182 commingled funds totaling $176.4 billion of gross real estate assets and reported an average debt ratio of 60.8 percent.

Part I: Investment Performance

Figure 1 examines the compound net total returns of equity REITs and the three types of private equity real estate funds for various periods ending December 2009. All returns analyzed were net of fees and expenses in order to more accurately reflect real performance.

Figure 1 – REITs Outperform in the Long Run
Compound net total returns for periods ending December 2009



Equity REITs had the highest compound net total return for four out of the six time periods examined. For example, for the one-year period ending December 2009, REITs had the only positive return (27.4 percent), while private equity real estate funds were all in negative territory (core: –30.4 percent, value-added: –41.0 percent, opportunistic: –30.1 percent). When analyzing a longer, 20-plus-year investment horizon (January 1989—December 2009), REITs were again the top performer with a compound net total return of 9.3 percent. Opportunistic funds came in second (6.1 percent), core funds third (4.4 percent), and value-added funds last (3.7 percent).

In order to further investigate this difference in performance, the study evaluated net total returns for 36-, 60-, and 120-month rolling periods, 1989 through 2009. The results indicate that private equity funds underperformed REITs for the majority of rolling periods analyzed. For example, when looking at 120-month rolling periods, core funds outperformed REITs only 18 percent of the time, value-added funds outperformed REITs 24 percent of the time, and opportunity funds fared best, outperforming REITs 62 percent of the time (highest frequency out of all periods examined).

Since real estate is subject to market fluctuations just like any other asset class, it may be revealing to examine and compare the performance of REITs and private real estate funds over the last full real estate market cycle. Table 1 summarizes the performance of REITs relative to private real estate funds over a full cycle, which lasted approximately 17 $^{3/4}$ years from peak to peak. Even though the peak dates are not exactly the same for the four real estate investment categories, the full real estate cycle is the same and a relevant time period for comparison purposes. The results show that REITs delivered higher returns, net of fees and expenses, than private real estate funds, both in cumulative and annualized terms. Over the course of the full cycle, REITs produced a cumulative net total return of 801 percent (13.4 percent annualized). Meanwhile, opportunistic funds had a cumulative net total return of 617 percent (12.0 percent annualized), value-added funds delivered a cumulative net total return of 320 percent (8.5 percent annualized), and core funds had the smallest cumulative net total return, 272 percent (7.6 percent annualized).

Table 1 – Net Total Returns of Equity REITs and Private Equity Real Estate Funds

	Full Cycle (Peak to Peak)		Bull Market Only (Trough to Peak)	
	Duration (years)	Returns	Duration (years)	Returns
Equity REITs	17¾ Sep 1989–Mar 2007	801% Cumulative 13.4% Annual	16¾ Sep 1990–Mar 2007	1,038% Cumulative 14.5% Annual
Core funds	18 Sep 1990–Jun 2008	272% Cumulative 7.6% Annual	15¼ Jun 1993–Jun 2008	341% Cumulative 10.2% Annual
Value-added funds	17 ¾ Sep 1990–Mar 2008	320% Cumulative 8.5% Annual	15 Jun 1993–Mar 2008	433% Cumulative 11.7% Annual
Opportunistic funds	17½ Sep 1990–Dec 2007	617% Cumulative 12.0% Annual	14¼ Dec 1993–Dec 2007	959% Cumulative 18.0% Annual

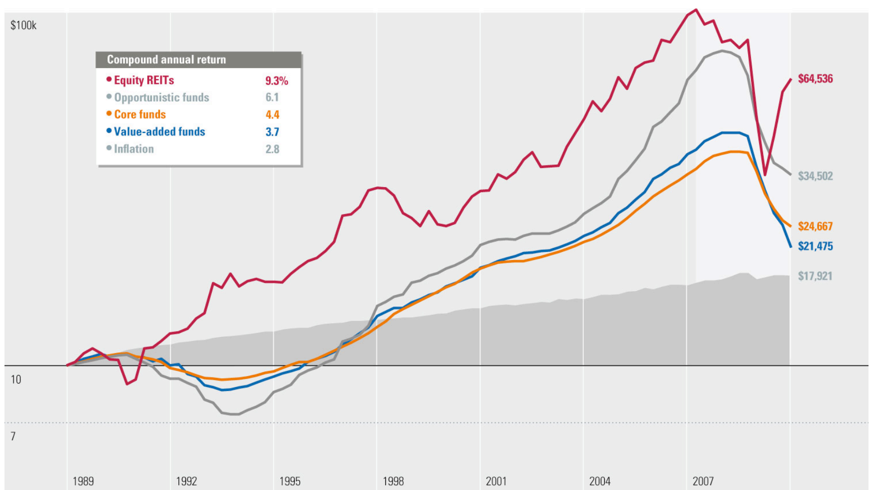
Table 1 also summarizes the same performance characteristics over the course of a bull market. When examining only bull markets (trough to peak) as opposed to the full real estate cycle (peak to peak), REITs again emerged with superior returns. REITs delivered a cumulative net total return of 1,038 percent (14.5 percent annualized), compared with 959 percent (18.0 percent annualized) for opportunistic funds, 433 percent (11.7 percent annualized) for value-added funds, and 341 percent (10.2 percent annualized) for core funds.

Part II: Public Market Efficiency

Part of the reason why REITs are able to provide higher returns than private real estate funds is that, as publicly traded companies, they enjoy more transparency. REITs are required to frequently prepare standardized financial statements and make them available to the public. This transparency supports timely and accurate performance measurement, and it also makes it easier for investors and markets to carefully monitor performance. In liquid and public markets, transparency facilitates more immediate re-pricing of assets than in private markets.

This advantage is illustrated in Figure 2, which depicts how REITs recovered from the 2007–2009 bear market. REITs declined faster, deeper, and more abruptly, but they also hit their trough earlier (in the first quarter of 2009) and immediately started their recovery. As of December 2009, all three categories of private real estate funds were still declining and had not reached their respective troughs.

Figure 2 – Public Market Pricing Is More Immediate and More Efficient
Net total returns for equity REITs and private equity real estate funds

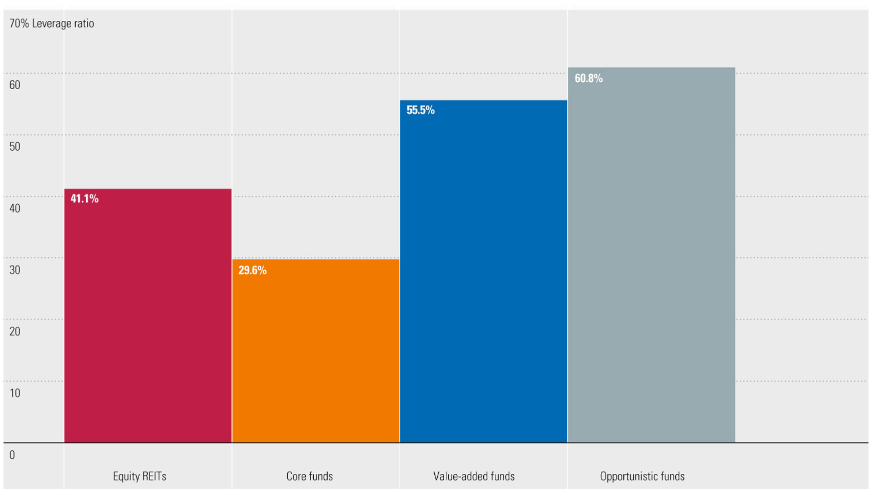


Prior to the most recent (2007–2009) downturn, REITs experienced two additional downturns since 1989. Core, value-added, and opportunistic funds each experienced one additional downturn. However, REIT downturns, although higher in number, were shorter and the recoveries happened faster when compared with private real estate funds. The two REIT downturns lasted for four and eight quarters, while the downturns for core, value-added, and opportunistic funds lasted for 11, 11, and 13 quarters, respectively. Similarly, REITs recovered three quarters after their first downturn and six quarters after the second one. Core and value-added funds took 13 quarters to recover, and opportunistic funds took 12.

Part III: Leverage and Fees

Leverage varies widely among different investments and therefore serves as a key to understanding return differentials. Figure 3 compares the leverage ratios of REITs with private equity funds.

Figure 3 – Higher Returns with Lower Leverage
A comparison of leverage ratios as of September 30, 2010

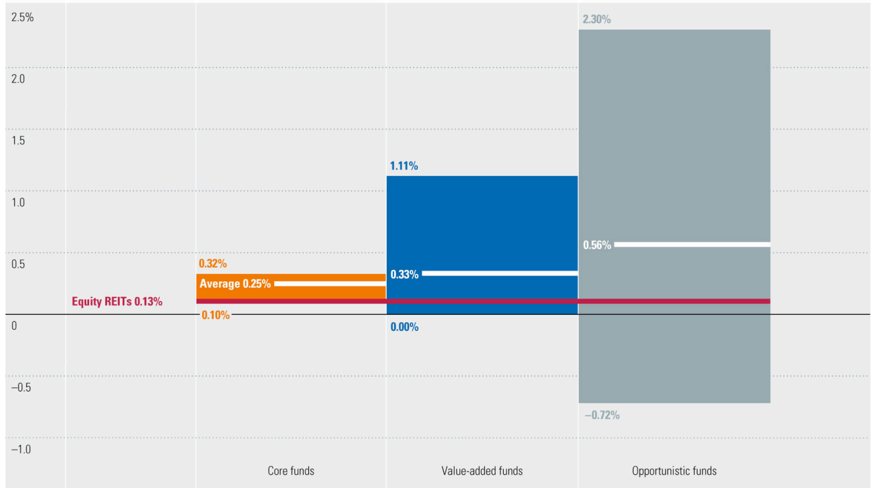


In general, REITs operate with less leverage than non-core private funds, which tend to be more aggressive. As of September 30, 2010, REITs carried, on average, a 41.1 percent leverage ratio, compared with 55.5 percent for value-added funds and 60.8 percent for opportunistic funds. Core funds carried 29.6 percent in leverage. Higher levels of leverage can mean more volatility that isn't compensated by higher returns.

Like leverage, costs vary widely among different investments, making fees and expenses an important consideration in investment selection. Figure 4 highlights the range of quarterly fees and expenses since 1989. Over longer investment horizons, higher fees can eat away at returns. In addition to providing higher returns, REITs also have lower fees, on average, than private real estate funds. Between 1989 and 2009, REITs had average quarterly fees and expenses of 0.13 percent, compared with 0.25 percent for core, 0.33 percent for value-added, and 0.56 percent for opportunistic funds.

It is interesting to note that, for the last quarter of 2008 and the first quarter of 2009, opportunistic funds actually reported negative fees and expenses (representing refunding of accrued fees). In the two quarters this occurred, the underlying funds had such low returns that the managers had to return the accrued fees to investors.

Figure 4 – REIT Fees and Expenses are Lowest
Range of quarterly fees and expenses, 1989–2009



The above results reveal that investors in private real estate funds may not be compensated for the high fees and risks of illiquidity. Therefore, higher allocations to private real estate funds within institutional portfolios may not be justified.

Part IV: Liquidity in Public and Private Markets

Liquidity is a major advantage for institutions managing liabilities, as evident from the recent financial crisis. Ignorance of illiquidity risk leaves significant sources of risk not captured by the financial performance measure, and thus severely underestimates the true risk of the thinly-traded asset.

REITs provide the complete liquidity of equities traded on public markets—evident from the significant growth in share and trading volume over the past 10 years. Over the past year (2010), the daily share volume for REITs has averaged 122 million with an average daily dollar trading volume of $3 billion as more investors have embraced the case for investing in REITs. On the other hand, liquidity in the private fund market, which is dependent on the underlying property market, diminished significantly between 2007 and 2009.

The Business Model

We have seen that REITs provide liquidity, transparency and public markets accountability and monitoring. REITs also operate in perpetuity, focusing on strategic long-term investing through selective acquisitions and dispositions.

The REIT business model encourages strategic decision making to manage income-producing investments, as well as more efficient allocation of capital to improve ongoing long-term returns. The REIT model also promotes disciplined use of capital (as REITs are required each year to distribute at least 90 percent of taxable income as dividends to shareholders), and recycling of capital to limit use of leverage.

REITs provide genuine "value-added" real estate investment by investing in core properties and all other property types, as well as by engaging in property development, redevelopment and repositioning.

In contrast, the private equity real estate fund model presents portfolio management challenges that include liquidating assets at predetermined fund termination dates for closed-end funds, investing in response to capital flows rather than market conditions, and selling assets on occasion to meet redemption demands in open-end funds, which may result in less strategic decision making on acquisitions and divestitures.

Figure 5 – Public REITs Net Sellers of Real Estate as Commercial Property Values Rose
(from 2006 to 2007)

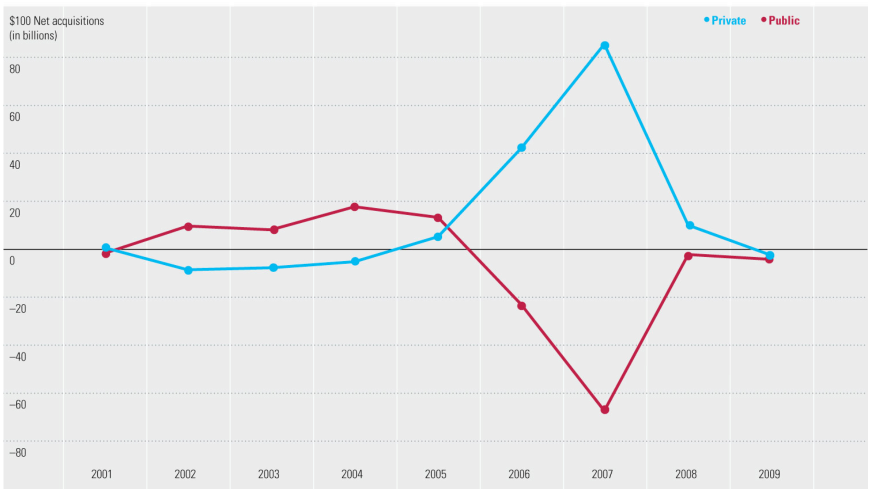


Figure 5 compares the net acquisitions of assets by REITs and private funds, which suggests that REITs were net buyers of commercial real estate assets, while funds were net sellers during 2001-2005. During the property price bubble of 2006-2007, REITs were net sellers of $86 billion of assets, while funds were net buyers of $49 billion of properties.

Conclusions

As evidenced throughout this paper, real estate investment strategies focusing only on private funds may not provide optimal risk/return tradeoffs for many institutional investors.

In addition to superior performance, REITs may contribute additional benefits to a portfolio, such as increased liquidity, transparency, and lower fees and expenses.

In the aftermath of the recent financial crisis, a new investment framework is needed for real estate, one that allocates more effectively along the market cycle and between public and private real estate.

With new data available, investors now have the opportunity to more effectively balance their real estate investments using both private equity real estate funds and publicly traded REITs to achieve the highest returns available commensurate with their investment goals and risk levels.

Data disclosure for images
Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. The returns represented herein are compound annual net returns.