



# REAL ESTATE LAW & INDUSTRY



## REPORT

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### PROPERTY INVESTMENT

## Who Will Be Declared the Winner in the Next Commercial Real Estate Bull Market?

By BRAD CASE

**T**he downturn in commercial property markets is still young and strong. There's no question that we've seen bad stuff already: the Transaction-Based Index published by Massachusetts Institute of Technology shows that property values have declined by 39.2 percent from their peak through the second quarter of 2009, and the Moody's/REAL CPPI shows them down 40.6 percent as of the end of August.

Still, swaps trading prices reported by Markit suggest that, as of the end of September, the National Council of Real Estate investment Fiduciaries Property Index (NPI) had recorded less than two-thirds of the total coming writedown in property values. And Real Capital Analytics, which reported on Oct. 22 that cap rates had started to fall globally, cautioned "but not in the U.S., where they continue to rise and show no signs of reversing course." RCA added that "the steady two-year rising cap rate trend in the U.S. is being fed by the growing tally of distressed assets, which is keeping downward pressure on prices."

That continues to be bad news for overleveraged real estate investors. As of the end of the second quarter—back when the NPI had recorded only about 57 percent of the total coming decline in property values—

opportunistic funds had already lost 52 percent, according to the NCREIF/Townsend Fund Indices, helped along by leverage averaging a reported 66.5 percent. And the high-flying opportunistic funds were not alone: even core funds, according to NCREIF's ODCE index, had lost 36.3 percent from their peak by the end of the third quarter, and were sitting on 33 percent leverage.

But the downturn in property values will someday end—roughly in 2012, according to the swaps trading—so forward-looking investors need to be thinking now about how they can best participate in the next bull market.

**Who Won in the Last Bull Market?** During their previous bull market, which lasted from the second quarter of 1993 through the second quarter of 2008, according to ODCE, core funds returned 341 percent after fees and expenses—meaning that investors who put, say, \$100 million into the average core fund could expect to have \$441 million at bull market's end. That's a respectable return for a core investment, averaging to 10.4 percent per year. But after all, unlevered property returns returned 322 percent, or 10.1 percent per year, over the same period—which implies that core funds using an average of 20 percent leverage should have returned nearly 11 percent per year. The funds fell short.

After all, though, the bull market is when leveraged investments really shine, and also when value can best be added and when opportunities should abound. So let's look at the performance of funds that were not afraid of taking on more risk to goose returns during an upswing. In their bull market from the second quarter

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of 1993 through the fourth quarter of 2007, according to the NCREIF/Townsend Fund Index, value added funds returned 430 percent net, and opportunistic funds returned even more—964 percent—during their bull market.

Now let's look at publicly traded equity REITs. The REIT bull market started considerably earlier in the third quarter of 1990 and ended slightly earlier in the first quarter of 2007. During that time equity REITs returned even more than opportunistic funds: 1,041 percent (again, net of fees estimated at 50 basis points per year, compared to 107 for core funds, 131 for value added funds, and 221 for opportunistic funds).

That means REIT investors gained 8 percent *more* than opportunistic fund investors—even though opportunistic funds used dramatically more leverage, and even though we've restricted our view to bull markets when highly leveraged investments shine their brightest. It means that REITs returned \$2.42 for every \$1 returned by value added funds, \$3.05 for every \$1 returned by core funds, and \$3.23 for every \$1 returned by unlevered core property investments.

And REIT investors had a bonus whose value has been dramatized clearly by the end of the bull market: investors can sell. REIT investments are fully liquid, so investors can sell at the peak (if they can identify it), locking in those bull-market returns. Fund investments are, of course, hugely illiquid, which means that fund investors couldn't do much about the rapidly declining values of their fund shares, even when they could clearly see the market peak. And no investor holding the stock of a publicly traded REIT has ever faced a capital call—least of all when the investor was in its own liquidity crisis.

**Who Wins Over a Full Cycle?** Of course, calling peaks and troughs is difficult business, so it's perhaps misleading to look only at bull-market returns. (After all, opportunistic fund managers were targeting net returns in the range of 20 percent per year—that is, higher than they returned during the last bull market—as late as 2006, just before the worst commercial real estate crisis since the 1930s began.) A more accurate comparison would look at returns over an entire business cycle, which we can identify as the period from one market peak to another.

For core funds, the market cycle ran from their peak in the third quarter of 1990 prior to the last downturn through their peak in the second quarter of 2008 prior to the current downturn. Over that full cycle they returned 272 percent, or 7.7 per year—again, a respectable return for core investments, but disappointing given that unlevered property returns were 266 percent (7.6 percent per year), meaning that leverage at 20 percent all by itself would have goosed their annual returns to 7.85 percent. Again, the funds fell short.

Value added funds? Their value added amounted to a full-cycle return of 318 percent, or an average of 8.6 percent per year. Opportunistic funds? Their opportunities amounted to 621 percent over the full cycle, averaging 12.1 percent per year.

What about equity REITs, with their too-pedestrian-to-be-tolerated liquidity and accessibility? They returned 802 percent, net of fees and expenses, over the full cycle. That means, over a full cycle, REITs returned \$1.29 for every \$1 returned by opportunistic funds, \$2.52 for every \$1 returned by value added funds, \$2.95

for every \$1 returned by core funds, and \$3.02 for every \$1 returned by unlevered core property investments.

**Why Are Private Equity Funds Inept?** The trouble with comparing returns of investment managers who use different amounts of leverage is that the leverage obscures actual performance in generating asset-level returns. To make the comparison easier, we de-lever returns, using an assumption that the long-run average cost of capital is 6.5 percent.

The realized average peak-to-peak return of 7.7 percent per year for core funds implies that they achieved unlevered property returns averaging about 7.45 percent, assuming they use 20 percent leverage on average. For value added funds, the realized average through-the-cycle returns of 8.6 percent per year implies unlevered returns of 7.49 percent, assuming 54 percent average leverage. For opportunistic funds the realized average of 12.1 percent implies an unlevered average of 8.34 percent, assuming 67.4 percent leverage.

For equity REITs, the 13.4 percent realized peak-to-peak returns, assuming average leverage of 42.4 percent, implies that REIT managers achieved unlevered returns averaging 10.46—roughly 25 percent higher than opportunistic fund managers, and 40 percent higher than core or value added fund managers.

What explains such unremittingly poor investment performance by private equity real estate fund managers? There are several likely factors—none of which bodes well for these vehicles going forward.

First, because they're so supremely illiquid, funds don't invest all of their contributed capital: they maintain cash reserves, partly to meet redemption requests (although, given the redemption queues in the current crisis, investors don't seem to have benefited much by it) and partly because buildings don't readily adjust their purchase prices to match the cash balances that fund managers have available. NCREIF's ODCE data suggest that cash reserves average about 4.2 percent at core funds—meaning fund investors face a built-in returns drag since less than 96 percent of contributed capital is actually put to work.

Fund manager investment actions, though, seem to present a far more serious drag on realized earnings. Green Street Advisors used data from RCA to investigate net commercial property transactions by public and private real estate investors during and preceding the asset price bubble. In 2006 and 2007, they found, net acquisitions by publicly traded REITs plunged: that is, they became enormous net sellers of commercial properties at the peak of the commercial property price bubble. Who picked up those assets at inflated prices? Private equity real estate funds, Green Street found: they became enormous net buyers of commercial properties at the peak of the price bubble.

Is that because they follow a buy-high, sell-low strategy? Well, not exactly a strategy—but it amounts to the same thing, for their investors. Fund managers buy properties when they can get money to do so—that's their strategy.

For example, net assets invested in value added funds more than tripled during the last two years before the market peak in the third quarter of 1990, even after eliminating the growth attributable to investment returns. Conversely, net assets invested in value added funds changed almost not at all during the last two

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years before the market trough in the second quarter of 1993 after taking into account their decline through (negative) investment returns.

Fund managers can't sell properties at their peak with so much new capital coming in; nor can they buy properties at their trough with no new capital. Instead they have to buy when they receive new capital; they have to hold—or even sell—when they don't.

What about publicly traded REITs? If new investor capital comes in, there's no mechanism through which REIT managers are forced to buy properties at peak prices; if investor capital is pulled out, REIT managers aren't forced to sell into a weak market. Instead, REIT managers return capital to investors through dividends when they have the opportunity to sell into an asset price bubble—as they did in 2006 and 2007. And when

there are buying opportunities, they raise capital through other means—as they have been doing this year, and are likely to continue doing for the next three years or so.

The private equity real estate fund industry will continue to buy high and sell low, because the fund model leaves no room for a better way. On the public side, there is a better way: the tremendous REIT dividends during the asset price bubble were simply the REIT way to return capital after pursuing the sell-high part of their strategy—and the ongoing recapitalization of the REIT industry is simply the REIT way to obtain capital for the buy-low part of the strategy.

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