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TRANSACTION VOLUME

Real Estate Transaction Volume Starts to Pick Up: Who Does That Benefit?

BY BRAD CASE

Early signs of an uptick in commercial property transaction volume will likely bring out varied responses among market participants. Some investors—those holding assets that are well-capitalized and well-managed—will breathe a sigh of relief as transactions reveal the value of their holdings and make it easier to tap capital markets. Others, though—those investment managers that, on behalf of unfortunate clients, both paid too much and used too much debt—will suck wind instead, as transaction activity exposes their weak holdings, closes down their sources of capital life-support, and herds them into the slaughter pen with the other distressed owners.

Real Capital Analytics and CoStar both reported a recent uptick in transaction volume, with CoStar noting on March 3 that ''large dollar property sales seem to be emitting faint sparks of hope for the commercial real estate outlook so far in 2010,'' and RCA interpreting the same phenomenon on Feb. 25 as a sign ''that sellers—whether owners of healthy assets or lenders seeking resolution of troubled properties—are becoming much more serious.''

That's good news for the market—not because it means that prices are on the rebound (actually, most of the market still has quite a bit of downward ground to cover: CoStar quoted Bob Bach, chief economist at Grubb & Ellis, saying that ''the pricing correction is [still] probably [only] two-thirds to three-quarters over with''), but because transaction volume brings clarity, and clarity is essential for productive feedback.

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A well-functioning market serves an absolutely critical purpose: to direct capital to its most productive—and therefore most rewarding—application. But productive feedback is essential to that process: if capital is misdirected, then its returns are poor, and the investment manager that misdirected it should be replaced by one who can more successfully identify its best application.

The problem is that investment managers who can't use capital well—who should be replaced—don't have an interest in a well-functioning market: they thrive on opacity, using it to disguise their bad bets and their poor returns. The best antidote to a failed investment manager's obfuscation is a transaction of properties held by his or her own fund—but a reasonable second-best is to have enough other transactions that the market flushes him out anyway.

In contrast, good investment managers thrive on transparency: their good decisions, and the superior returns they produce, are visible to all, so more capital flows their way. (Indeed, a good investment manager doesn't have to hide her ''secret recipe,'' because there's really no secret: superior returns are earned simply through superior execution.)

Real Capital Analytics went on to note that, ''in the New Year, lenders are apparently more willing to write

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down their losses after a prolonged carrying period and bring troubled assets to market.'' If this is true—if the era of ''pretend and extend'' is finally starting to end—then that's a piece of good news perhaps even better than the increased transaction activity.

Who Benefits? (Hint: Not 'Distressed Asset' Funds!) One group who will cheer the increase in transaction volume, as mentioned, are those who made good investments but whose access to capital has been clouded by uncertainty. There's another group who will trumpet the increase, but for a different—and not so heartening—reason: managers of private equity real estate funds selling a ''distressed assets'' strategy. That's because their mandate is to put committed capital to work, and if they're active, then it'll be easier for them to argue that they're ''earning'' their management fees. Don't buy it.

In any transaction, if there's a party who is seeking anything other than best value, then that party is ''motivated''—which is just another way of saying ''distressed''—and will generally be taken advantage of. Of course that defines many potential sellers—especially managers of private equity real estate funds (particularly those following disastrous ''opportunistic'' or ''value add'' strategies) that acquired assets during the fatal real estate bubble of 2005-2007. What many investors don't realize is that managers of private equity real estate funds are also ''motivated'' (or ''distressed'') when they're on the buying side—now, just as in 2005-2007.

That distress—and the poor returns that it entails—is a necessary by-product of the management fee that private equity funds charge on committed assets.

First, the management fee means that funds have an incentive to maximize their committed funds, even when there's no productive use for those funds. In 2005-2007 no even casually knowledgeable observer of the real estate market could think that there were many genuine ''opportunities'' to ''add value'' by acquiring assets at already-inflated prices. But that didn't prompt fund managers to turn away investor capital: they signed up as much committed capital as possible, and charged fees on it while they looked around for something to do with it. That's not a recipe for sound returns.

Second, the management fee means that investment managers are under pressure to invest capital once it has been committed. Because of that, in any real estate transaction a set of potential buyers—the fund managers—are motivated not merely by the likely returns but also by pressure to complete the transaction. The result—again, not a recipe for sound returns—is a perfect application of the ''winner's curse.''

The Winner's Curse. The ''winner's curse'' (as the problem was named originally by Richard Thaler) normally penalizes the potential buyer who most egregiously overestimates the value of a property. Here's how it works. Imagine that there are two potential buyers for the same property, each of which pays 7.5 percent for capital; one buyer correctly estimates the net operating income at $75,000 per year; but the other buyer is overoptimistic and estimates the NOI at $80,000 per year. The first buyer is willing to pay $1 million for the property (equal to NOI divided by the going-in cap rate of 7.5 percent), but the second buyer overbids at $1,066,667. The ''curse'' is that the successful buyer earns only 7.03 percent (the correct $75,000 NOI divided by the purchase price), meaning that the successful bid results in poor returns.

Of course, the winning bidder isn't always cursed; in some cases the winner is the buyer who truly can produce better NOI than its competitors, and/or has access to lower-cost capital. Independent academic economists have studied several aspects of this. One study, for example, suggested that publicly traded REITs systematically paid more for multi-family properties in the Atlanta metro area because they were able systematically to produce better NOI; several others have found that publicly traded REITs that (1) are more transparent, (2) have more investor-friendly governance structures, and/or (3) have more liquid markets for their investor shares have systematically lower cost of capital than their opaque, poorly governed, and/or illiquid competitors.

Now let's see what happens when we take into account the management fee structure standard among private equity real estate funds. Imagine two investors, both of whom correctly evaluate the NOI of the property at $75,000 and their cost of capital at 7.5 percent. One of them, though, is charging a management fee of 2 percent on committed capital, and fielding calls from frustrated investors asking why their committed capital isn't being put to work. The fund manager may already have started raising capital for a second fund—but fundraising is difficult if investors think the fund manager is slow to invest committed capital.

The outcome, of course, is that the fund manager will win the auction by paying too much: the $1,000,000 value of the property, plus the present discounted value of the additional fees that the fund manager can generate simply by being the winning bidder on this transaction. The investor's returns, of course, will suffer: but, in an opaque market, that won't be revealed until 10 years later—and, in the meantime, the fund manager will have generated all those wonderful fees.

There are three morals to the story. First, the fact that you've won a bidding war doesn't mean you've succeeded: it may mean simply that you made the biggest mistake—you blew it—on behalf of your investors. Even if you're a good property manager, your returns will be disappointing if your cost of capital is higher than expected; conversely, even if you have access to cheap capital, your investors will be disappointed if you can't manage the property to maximize NOI.

Second, the fact that you lost a bidding war doesn't mean you've failed: it may mean simply that you *didn't* blow it on behalf of your investors. (That's unless you're charging 2 percent on committed capital, in which case your investors are doomed if you do, and doomed if you don't.)

But the third moral is the key: if you're under pressure to put committed assets to work, then you're by definition a ''motivated'' (or ''distressed'') buyer—which means you're going to overpay, and therefore produce poor returns for your investors.

Of course, in many cases the winner's curse won't apply: as noted, some buyers rationally pay more because they systematically produce better NOI, or have lower cost of capital, or both. As transaction volume increases, then, how can we tell whether the winning bidders are producing stronger returns for their investors or are simply overpaying? The only way is by comparing long-term unlevered returns, net of fees and expenses.

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The best way to predict who will benefit from this budding upturn in the real estate market, then, is by looking at what happened in the last one. During the long bull market that lasted roughly from 1993 to 2008, unlevered net returns on core commercial properties averaged 322 percent according to the NCREIF Property Index. Private equity real estate funds following a ''core'' strategy used about 20 percent leverage but barely managed a better net return, averaging just 341 percent—far worse than core properties on an unlevered basis. ''Value-added'' funds used about 54 percent leverage but managed net returns averaging only 430 percent, while ''opportunistic'' funds used about 67 percent leverage but managed net returns of only 964 percent.

Where, please tell me, is the argument for the private equity real estate funds model, even in a bull market?

During the same long bull market, publicly traded equity real estate investment trusts produced average net returns of about 1,041 percent—far better than for unlevered property values *or* core funds *or* value-added funds *or* opportunistic funds.

As transaction volume picks up, keep an eye on who wins the bidding for the properties coming on the market. Separate them into two piles: one for successful bids that will earn strong long-term returns for investors, and another for examples of the ''winner's curse.'' The first pile should have the label ''publicly traded REITs'' affixed to it, while the cursed pile should be labeled ''private equity funds.''