

Equity or Debt? Public or Private?

An Overview of Investment Options



David J. Lynn, PhD
CEO and Founder, *Everest Investment Property*

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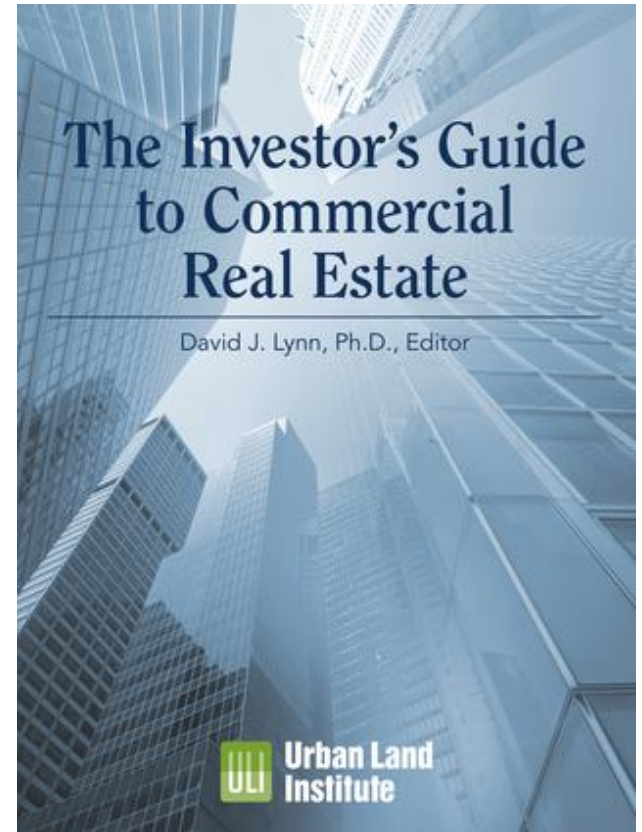
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Agenda

- Investment Products and Strategies
- Investing in Real Estate Funds and Deals
- Accessing the Returns and Liquidity of Public REITs

Reference available at www.uli.org/bookstore.



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Investment Products and Strategies



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Investment Products and Strategies

- Spectrum of Opportunities: The “Four Quadrant Model”

Four Quadrants of Real Estate Investment

	Equity	Debt
Private	Direct Investment in Real Estate	Direct Investment in Real Estate Mortgages
Public	Real Estate Investment Trusts (REITs) Real Estate Operating Companies (REOCs)	Commercial Mortgage Backed Securities (CMBS)



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- **Private Equity Investment**

- Done through equity interest in individual or groups of assets. The return profile is generally solid over the long term, driven mostly by income and faces the constraints of high initial capital requirements, low liquidity and long-term commitments.
- Done via a fund that pools capital from investors. Funds are actively managed over a ten-year horizon at which point properties are liquidated.
- Private equity investors tend to be institutions or high- net-worth investors due to high capital requirements/limitations.
- Returns can often be very lucrative—in excess of 20 percent annually for well- run funds (large firm examples include Blackstone, Lone Star, Brookfield, and Starwood).

• Public Equity Real Estate Securities

- Public real estate investing is done through individual REIT stocks and REIT mutual funds, or through property managers, brokers, or developers.
- ETFs have also gained in popularity. An ETF is an investment fund that trades similar to a stock.
- Investing in public real estate offers the unique advantage of high liquidity, which allows investors with a low capital base to enter the space.
- The primary disadvantage of public real estate investment is high exposure to macroeconomic risk factors, which create general stock market volatility.
- Examples of large REIT mutual fund managers include Cohen & Steers, Fidelity, TIAA-CREF, Invesco, T. Rowe Price and others.

- **Whole Mortgages**

- The nature of real estate debt investing
- Pros: offers the potential for stable yields because the loans have to be repaid in the manner specified in the legal loan documents, including the stated interest rate, which is often fixed.
- Cons: some loans carry floating rates.

- ## Mezzanine Loans

- Between the first mortgage and the equity position there is a type of funding called mezzanine loans. Their function is to bridge the gap between what the owners of a property can or will contribute in equity and the amount that a lender is willing to provide for a first mortgage. As such, they are thought of as a hybrid subordinated debt/preferred equity investment. The collateral for the loan is the equity in the property, not the property itself. Therefore, if the borrower of the loan defaults, the lender assumes the equity in the building, but is still responsible for repaying the first mortgage.
- Mezzanine loans are repaid after the first mortgage. Consequently, they are a riskier proposition and carry higher interest rates than first mortgages carry. In addition to the higher yield that the loans command, these loans often have an equity participation component as well.

Investment Products and Strategies

- ## CMBS Bonds

- Commercial mortgage-backed securities (CMBS) are bonds backed by loans that are secured by commercial real estate assets as their collateral. The majority of the issuances are structured as real estate mortgage investment conduits (REMICs), which obtain a diverse pool of mortgages in order to issue mortgage-backed securities to investors.
- Commercial mortgages are pooled together and “warehoused” until the securities are underwritten and sold to investors, then the bonds are tranching, or divided into categories, based on risk. This risk is largely determined by how quickly and under what circumstances the holders of the bonds are repaid. The sooner and easier it is for the bond holder to be repaid, all else being equal, the lower the risk and the lower the return.
- These individual tranches are often rated by an independent credit-rating agency, similar to the way conventional fixed-income investments are rated. They are generally broken down into two broad categories. Tranches that are deemed investment grade carry one of four general ratings: AAA, AA, A, and BBB. Noninvestment grade tranches carry one of the lower ratings: BB, B, C or worse.

- **Unsecured REIT Debt**

- Unsecured REIT debt concerns entity-level corporate bonds that are issued by the REITs themselves. The unsecured debt is backed by the cash flows of the corporation issuing the bonds and consequently it is primarily thought of as a corporate bond, not a real estate investment. This provides the bonds with somewhat higher liquidity. However, the loans are not secured by individual properties and upon default the bondholders do not have the right to assume control over the buildings themselves. The bondholders have to go through the conventional channels and remedies available to corporate bondholders, including bankruptcy proceedings.
- Because REITs use modest amounts of leverage, these investments are considered attractive by many investors. The REITs' stable cash flows are ultimately derived from the properties that they own and the associated leases. This makes it relatively easy to make unsecured debt-service payments. That stands in contrast to the volatility that can be found at more mainstream corporations, making the bonds very attractive to some investors.

- Mortgage REITs

- Somewhat of a hybrid investment, mortgage REITs are companies that own and invest in commercial real estate mortgages. The REITs either make direct loans to property owners or they purchase whole mortgages and CMBS bonds in the secondary market.
- Although the mortgage REITs do not own or operate real estate assets, mortgage REIT shares are an equity investment because the shareholder is an owner of the corporation that owns the underlying debt assets.

Investment Products and Strategies

• High-Yield Debt

- High-yield debt is a relatively risk-averse investment strategy, but it takes somewhat greater risks than whole mortgage strategies and offers higher returns.
- The B and C portions of the first mortgage can be carved out and invested in separately. Although technically still part of the first mortgage, because they are in a subordinated position they will carry marginally higher risk and returns.
- Mezzanine loans can be utilized. These loans have higher loan-to-value ratios, lower coverage ratios, and are in a subordinated position to the entire first mortgage. Consequently, they boast a bit higher risk and return, including the potential for equity participation upon sale.
- Loans can be made on lower-quality buildings. These buildings could be under-maintained or in smaller, less liquid markets. They could also be loans for secondary or even tertiary property types.
- Loans can be made for construction and development projects. These are considered risky because, unlike existing buildings that have their space leased well and are generating cash flows, these assets do not generate cash flows during the construction period. Debt-service payments can be paid on an ongoing basis or sometimes can be deferred until the project is completed and the loan is repaid.

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Investing in Real Estate Funds and Deals



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- What is Private Equity Real Estate Investing?

- Private equity strategies seek to make entity-level investments in private real estate companies. Although the assets owned by the firms are real estate assets, these investments also implicitly make a bet on the management and the organization itself requiring a different form of due diligence than when making direct investments in properties. Investors can actively become involved in managing the company, which prompts many considerations and decisions that are not necessary when investing in properties.
- Usually, the firms themselves are rather focused, investing in a limited number of property types. Therefore, funds that make investments at the entity level attempt to diversify by investing in a variety of organizations and then by employing the diversification techniques that other real estate managers use, for example, diversifying by property type, geography, and economics. These investments can be risky and rather long-lived due to the amount of time it can take organizations to grow and thrive.

- ## Why Choose Private Equity Real Estate Investment Funds?

- There are a range of options and each is well suited to specific investor goals and types of real estate assets. Publically listed REITs are the right option for some investors because they offer the greatest level of liquidity and make it easy to have a high level of diversification. Private equity real estate investments offer lower volatility, limited correlation with the equity markets, a more direct link between real estate performance and investment performance, and a wider range of investment strategy options.
- In comparison to direct real estate investment, private equity funds offer greater diversification, lower investment minimums to achieve diversification, access to higher quality real estate assets, less idiosyncratic risk, and less time for monitoring and management. Within private equity real estate fund investment there is a wide range of options and choices, and matching those to the investor situation is critical.

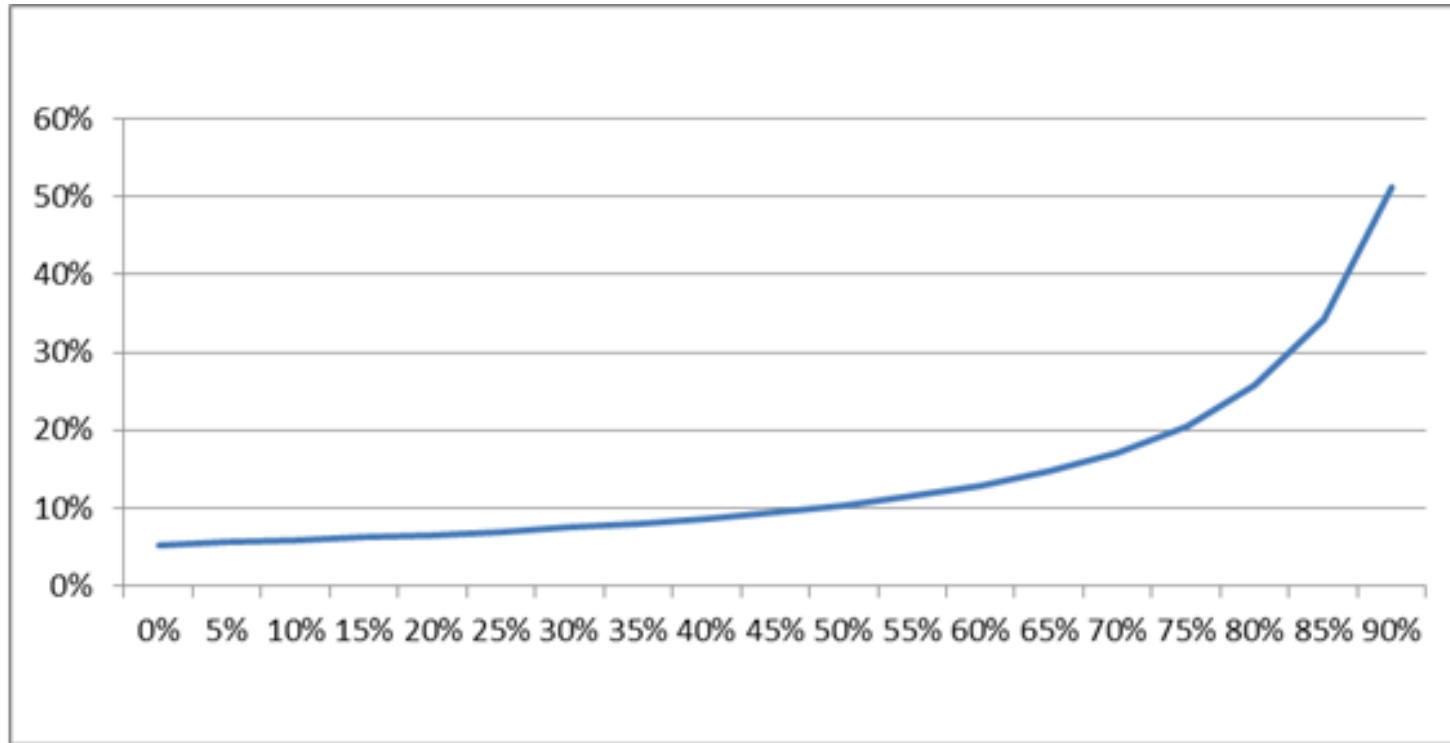
Investing in Real Estate Funds and Deals

• Fund Characteristics

- The most common legal structures for real estate funds are private partnerships and a REIT structure. A REIT structure does not mean that shares are traded on an exchange; rather it is a corporate structure that provides protection from corporate taxes in exchange for certain restrictions on asset ownership and trading activities.
- The restrictions on non-real-estate- related income mean that investing in operationally intensive real estate (such as casinos, nursing homes, and parking garages) can be more challenging, but not impossible. The restrictions on trading activities mean that assets generally need to be held for two years before being marketed for sale, which can be an issue for development or building renovation investment strategies.
- Private partnerships do not have these restrictions on business activities or trading but each investor shares in the tax burden of the fund. Private partnership investors receive a K-1 tax statement as opposed to the simpler 1099 tax statement that REIT investors receive.

Investing in Real Estate Funds and Deals

Standard Deviation of Real Estate Returns Increase at Higher Leverage Levels



Source: NCREIF, LaSalle Investment Management. Based on NPI return history with borrowing rate in each period as 1 year LIBOR + 300 basis points



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Investing in Real Estate Funds and Deals

Pros and Cons of Real Estate Debt

Characteristic	Comments
Loan Term	The typical borrowing term ranges from three to ten years. Because prepayment is sometimes prohibited or expensive, the loan term should be matched with fund life and asset characteristics.
Recourse	Recourse loans give the lender access to other fund assets and limit the put option related to debt. Nonrecourse loans limit losses to a single asset.
Fixed or Floating Rate	Fixed-rate loans provide protection from interest rate increases, while floating-rate loans allow for pre-payment.
Prepayment	Restrictions on pre-payment limit flexibility on timing of sale, but are often required for fixed rate loans.
Cross-Collateralization	Cross-collateralized loans tie several properties together in the same borrowing. This can lower interest rates and allow for higher leverage, but can restrict ability to sell assets and limits the ability to default on bad investments.

Investing in Real Estate Funds and Deals

Key Performance Metrics

Performance Metric	Definition	Attributes	Types of Funds
Income Yield or Income Return	Net Operating Income / Value	Measures performance and valuation of fund. Functions as the inverse of a P/E ratio.	Primarily Core, Open-End Funds
Appreciation Return	Change in Value / Value	Measures the increase in value of a fund.	Primarily Core, Open-End Funds
Total Return	(Net Operating Income + Change in Value) / Value	Measures the performance of a fund in a given period and over time. Useful for comparison to real estate benchmarks.	Primarily Core, Open-End Funds
Cash Return	(Net Operating Income minus Capital Expenditures) / Value	Measures the cash available for distribution to investors.	Primarily income-oriented funds
Dividend Yield	Cash Distributed to Investor / Value	Measures the cash return distributed to investors	Primarily income-oriented funds
Funds from Operation (FFO)	Cash flow from operations. Net Income plus depreciation and amortization	Measures cash a fund generates from operations. Used by REITs as an adjustment to Net Income	Primarily for REITs
Adjusted Funds from Operation (AFFO)	The FFO minus capital expenditures to maintain quality of assets	A good measure of cash available for distribution on a GAAP reporting statement.	Primarily for REITs
Internal Rate of Return (IRR)	Metric of total cash flows to and from investors	Measures the total return of a fund over its life.	Closed-end funds
Equity Multiple	Capital Returned to Investors / Capital Invested	Measures the total capital return of an investment over time.	Closed-end funds

Investing in Real Estate Funds and Deals

Common Fund Fees

Fee	Description
Asset Management Fee	Annual fee based on total invested equity
Front-End Load	Fee paid upon commitment of capital
Acquisition Fee	Charges and commissions paid for the acquisition of property, such as closing costs, commissions, and development or construction fees
Disposition Fee	Sometimes paid for completing work to sell as property
Commitment Fee	Fee paid to keep unused credit line or undisbursed loan open
Incentive Fee	Fee dependent upon fund manager's performance



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Accessing the Returns and Liquidity of Public REITs



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Accessing the Returns and Liquidity of Public REITs

- Property Types

Category	Examples
Office	CBD, suburban, flex, specialized
Industrial	warehouse, logistics, R&D
Retail	Malls, neighborhood shopping centers, free standing
Residential	multi-family (apartment, student, seniors, single-family, service apartments) and single family homes
Land	undeveloped, agricultural
Leisure	Full service hotels, motels, resorts
Healthcare	hospitals, medical office, life science, assisted seniors, skilled nursing
Miscellaneous	storage, timber, datacenters, infrastructure

- REITs and Non-REIT Real Estate Companies

- US REIT may be a public company with its shares registered with the SEC, or it may be a private company. A public REIT's shares may be listed on an established stock exchange, or its shares may be unlisted and sold directly to investors through a broker-dealer. At the end of 2012, 288 REITs in the US were registered with the SEC, and 195 of those REITs were listed on established US stock exchanges (predominantly on the New York Stock Exchange). Of the 288 SEC-registered REITs, 90 percent (by total assets) were stock-exchange-listed REITs, and 10 percent were public nonlisted REITs.
- Private REITs are not registered with the SEC and are not open to most investors. In fact, some private real estate investment funds may elect to be organized as REITs. Because they are not subject to SEC financial reporting and disclosure requirements, however, little information is available with respect to the investment performance of private REITs and they are not considered further in this chapter.

Accessing the Returns and Liquidity of Public REITs

- **Listed and Non-Listed Public REITs**
 - Public companies must register their securities (such as stock shares) with the SEC for sale to investors, but not all securities are traded on exchanges. Listed companies are those public companies whose stock shares can be bought and sold on organized exchanges, such as the New York Stock Exchange or NASDAQ.
 - Other public companies, including some REITs, sell their stock only through broker dealers or other agents. Such companies are commonly called public nonlisted REITs, or PNLRs. Although the shares of PNLRs must be legally transferable (as required by the ownership test), there may be restrictions on transacting shares except with the REIT itself. In fact, investors ordinarily own PNLR shares through the entire life of the company, until its assets are liquidated and distributed to shareholders or until the PNLR elects to list its shares.

Accessing the Returns and Liquidity of Public REITs

- ## Equity and Mortgage REITs

- Acquiring and managing real estate equity and debt assets require different business strategies and practices. Owning real estate equity requires expertise in valuing real properties by estimating their capital and operating expenses, occupancy rates, and market rents; negotiating the terms of property transactions; marketing and leasing the properties; providing property-related services such as cleaning, maintenance, and security; and perhaps designing and constructing new properties. In contrast, owning real estate debt requires expertise in valuing mortgages by estimating their probabilities of default and prepayment and the expected losses in case of default; managing financial risks; and maintaining a profitable spread between payments made on borrowed capital and income received on owned mortgages or mortgage-backed securities.
- REITs that primarily own real property are known as equity REITs, while those that primarily own mortgages and mortgage-backed securities are known as mortgage REITs. Before the early 1990s mortgage REITs comprised a large share of the listed REIT industry, and there were several hybrid REITs holding both types of real estate assets. Equity REITs, however, have accounted for most of the growth in the REIT industry since the early 1990s and today comprise about nine-tenths of the listed REIT industry, while hybrid REITs holding both real properties and mortgage assets have become rare.

• Internally and Externally Managed REITs

- The market's interest in equity REITs initially was limited because the ownership and management of assets were required to remain separate under the initial REIT rules. Consequently, REITs originally were required to hire an external firm to advise them on acquisitions and to manage their asset portfolio. The external management firm is paid a management fee based on the value of the assets owned by the REIT, plus an incentive fee based on the performance of the asset portfolio.
- The management restriction changed with the passage of the Tax Reform Act of 1986, which permitted REITs to both own and manage their properties as vertically integrated companies, and the majority of the listed equity REIT industry today is internally managed. Some academic studies have suggested that internally managed REITs tend to outperform otherwise similar externally managed REITs—perhaps because the external management fee structure may affect performance incentives—and investors generally appear to prefer internal management.

Accessing the Returns and Liquidity of Public REITs

- **Domestic and International REITs**

- The REIT approach to real estate investing was first developed in the United States, today every G-82 nation, with the exception of Russia, has adopted a model for REIT-based real estate investment. Additionally, a majority of countries that are members of the Organisation for Economic Co-operation and Development (OECD) have adopted their own REIT models. US neighbors, Canada and Mexico, have REIT models in place. All these countries have chosen to follow, more or less, the pioneering experience set forth by the United States to democratize the real estate asset class.
- The FTSE EPRA (European Public Real Estate Association) /NAREIT (National Association of Real Estate Investment Trusts) Global Real Estate Index Series is the leading investment benchmark worldwide for stock-exchange-listed REITs and real estate equity securities in both developed and emerging economies. The Global Index as of September 30, 2013, included 446 companies with a combined equity market capitalization of approximately \$1.2 trillion worldwide, of which two-thirds is listed equity REITs. The largest listed real estate company in the world – Simon Property Group – is a US REIT, and US REITs represented twelve of the largest listed real estate companies worldwide.

Accessing the Returns and Liquidity of Public REITs

- **Owner-Occupied Housing**

- Single-family houses can be owner-occupied or owned by a REIT or other manager for rent to their occupants. Investment advisors sometimes ask whether clients who own their own homes (and perhaps even vacation houses) already have adequate exposure to the real estate asset class without investing in income-producing real estate through REITs or otherwise. Owner-occupied housing is not—and should not be considered—an investment asset, despite the fact that any price appreciation accrues to the owner's wealth.
- Primary and vacation homes are consumption goods that are selected and purchased because they are located where buyers want to live and vacation, and because they embody the amenities—neighborhood, proximity to work and schools, living space, configuration, etc.—that buyers are willing to pay for. Owner-occupied housing produces little capital appreciation over time when compared with other investment assets and little, if any, net operating income. Most of the financial benefit from owning a house comes from the implied value of the rent that the owner would otherwise have paid.

Accessing the Returns and Liquidity of Public REITs

• Mechanics of Investing in Public Real Estate

- At the end of September 2013, there were 193 listed REITs in the US with an aggregate equity market capitalization of \$660 billion and average daily dollar share trading volume of about \$5 billion. The minimum investment in listed REIT stock is one share. Investors also may invest in listed REITs by purchasing shares of mutual funds focused on the real estate industry or a given sector of it. There are currently at least 140 mutual funds that focus on listed REITs and REOCs, many of which are open to new investors. Mutual funds pool investor capital to purchase shares of REIT stock; dividends are distributed to mutual fund investors on a pro-rata basis, and REIT share price appreciation is reflected in an increase in the net asset value (NAV) of mutual fund shares.
- Another way to invest in listed REITs is to purchase shares of an exchange-traded fund (ETF) that focuses on the real estate industry or a sector of it. There are currently at least twenty-eight ETFs focused on listed REITs and REOCs. ETFs issue stock shares that are listed on stock exchanges; similar to mutual funds, then purchase REIT stock shares with the capital raised through their issuance of ETF shares. Dividends paid by REITs are distributed as dividends to ETF shareholders, and changes in REIT share prices are reflected in corresponding changes in ETF share prices.

Accessing the Returns and Liquidity of Public REITs

- Dividends

- REITs must distribute at least 90 percent of taxable income to investors (the distribution rule); most REITs distribute at least 100 percent of taxable income. As a result, REITs provide steady income that accounts for the majority of total returns: for example, an initial investment of \$10,000 at the end of 1999 in the US listed REITs represented by the FTSE NAREIT All Equity REITs Index would have generated cumulative dividends of \$47,124 as of September 2013, along with \$40,781 in share price appreciation.
- For comparison, the same initial investment in the listed companies represented in the Standard & Poor's 500 Index of large-cap stocks would have generated just \$13,514 in cumulative dividends plus \$39,037 in share price appreciation.

Accessing the Returns and Liquidity of Public REITs

• Personal Income Taxes

- REIT distributions are reported to investors and to the IRS using the same 1099-DIV form used for the dividends of non-REIT public companies.⁶ Each REIT identifies the portion of its annual dividend distribution that represented net operating income, and that share of the dividend is treated as ordinary income for personal income tax purposes. A different portion of the distribution may represent gains from the sale of real estate assets held by the REIT; that share of the dividend is treated as long-term capital gain for income tax purposes and therefore subject to a lower tax rate.
- REITs are permitted to distribute more than 100 percent of their taxable income to shareholders and many do so. Any such “excess” dividend is identified as return of capital, which reduces the taxable basis for determining capital gain when an investor sells REIT stock shares and therefore benefits from the lower long-term capital gains tax rate.
- Based on the 1099-DIV statements from as many as 121 listed REITs for calendar years 2010- 2012, ordinary income accounted for 70 percent of total listed REIT dividend distributions to common shareholders with the remainder evenly divided between long-term capital gain and return of capital.

• Measuring and Benchmarking Real Estate Investment Returns

- Returns of listed REITs—income, capital appreciation, and total return—are measured accurately by numerous benchmarks, such as the FTSE NAREIT US Real Estate Index Series (for US listed REITs) and the FTSE EPRA/NAREIT Global Real Estate Index Series (for global listed REITs and LPCs), maintained and published daily by FTSE, a London-based company that calculates more than 120,000 performance benchmarks for public investments covering more than eighty countries and all major asset classes. Income returns are measured on the basis of actual distributions, while capital appreciation is measured on the basis of actual stock transactions for companies holding approximately 40,000 income-producing real properties in the United States.
- Income returns of actual investments in private real estate are measured accurately by the NCREIF Property Index (NPI) and the NCREIF Transaction Based Index (NTBI) published quarterly by the National Council of Real Estate Investment Fiduciaries, a consortium of institutional investors and investment managers that aggregates data on approximately 7,000 income-producing real properties in the US.

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Questions & Answers



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David J. Lynn, PhD
CEO and Founder, *Everest Investment Property*

email: dlynn@everest-ip.com



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