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With the availability of streamlined, tech-powered CRE investing platforms and low minimums, investors can diversify across platforms, operators, property types, markets, and risk/return profiles.

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The nuts and bolts of private commercial real estate investing

This diverse asset class can deliver both solid cash flow and solid total return potential

REAL estate investing means different things to different people. It can be shorthand for buying a rental property – taking out a mortgage, finding a renter, and hoping to clear the monthly cost while the asset appreciates. It can also mean buying shares in a public real estate investing trust (Reit), the kind that has been around for decades and is accessible through most brokerage accounts.

But real estate as an asset class is much more diverse than that. Broadly speaking, commercial real estate (CRE) may refer to many different types of property, investment theses, and risk/return profiles. Fintech-enabled investing has made private-market CRE as accessible as stocks and index funds, albeit at a higher minimum investment. Indeed, private-market CRE investing and Reits also both offer the benefit of (divisible) passive investing – no “tenants and toilets”, as they say.

What is CRE investing?

CRE is any real estate investment or transaction undertaken by a professional investor. The term “commercial” can also denote multi-tenant, in-

cluding multifamily. Because of CRE properties’ size and operational complexity, these transactions tend to involve multiple parties and offer alpha opportunities.

In principle, two factors drive CRE returns: rent and appreciation. Hence, CRE is one of the few asset classes that can deliver both solid cash flow and solid total return potential.

Following the Jumpstart Our Business Startups Act (Jobs Act) of 2012 in the United States, CRE syndication developed with various platforms providing a nexus between real estate investment firms, or sponsors, and networks of individual investors. These investors could passively invest in CRE with substantially lower, divisible barriers to entry. Access to private CRE investing has thus expanded dramatically over the past decade.

So, what are the potential benefits of private-market CRE investing relative to other forms of real estate investing?

■ As an asset class, private-market CRE has shown lower correlation to public equity and bond markets than public Reits. Between 1990 and 2015, public Reits showed a correlation of

between 0.48 and 0.80 with major stock market indexes. For private CRE, the correlation was between 0.06 and 0.12.

■ Private-market CRE investments can demand an illiquidity premium. Their positions cannot be traded on exchanges like public Reits, and hence tend to carry greater total return potential by rewarding investors for assuming that liquidity risk. Alternative investment classes can carry an illiquidity premium ranging from 2.74 per cent to 9.91 per cent.

■ Illiquidity also means a greater opportunity for passive investors in private-market CRE to tap into alpha. As with other alternative investment classes, sponsor selection is key. Sponsor performance introduces significant return dispersion in the top 5 per cent through bottom 5 per cent range, with as much as 15 per cent to 25 per cent difference in expected returns across different CRE investment styles.

■ Information asymmetry, geographic barriers to entry, and other private market inefficiencies give sponsors/CRE operators more opportunity to enter or exit a given investment at an opportune time on favourable terms.

Common types of CRE investments

The four main CRE sectors, or sub-asset classes, are Multifamily, Office, Retail, and Industrial. A variety of other sub-asset classes, such as lodging, self-storage, data centres, and more exotic variants such as communication towers, are CRE's "niche" sectors.

Of course, with time, real estate operators innovate and expectations from tenants evolve. Macroeconomic shocks such as the Covid-19 pandemic create new demands on the built environment.

As such, the lines between CRE property types may blur, and new sub-asset classes like medical office buildings (MOB) may emerge. On an institutional scale, certain properties may be mixed-use, comprising any combination of residential/office, lodging, and retail.

Because the investment thesis tends to be straightforward, and the underlying function is so essential, 'multifamily' tends to dominate online CRE investing platforms.

CRE transactions involve debt – analogous to a mortgage for a single-family property – as well as equity, which is akin to the owned portion of a home that grows in value as the asset appreciates. Due to the size and complexity of CRE transactions, there is often a middle layer of financing: subordinated (mezzanine debt), preferred equity, or both.

The capital stack is the combination of financing instruments for any one CRE transaction. CRE investors may participate anywhere in the capital stack and tend to access such opportunities through online platforms, with common equity positions the most prevalent.

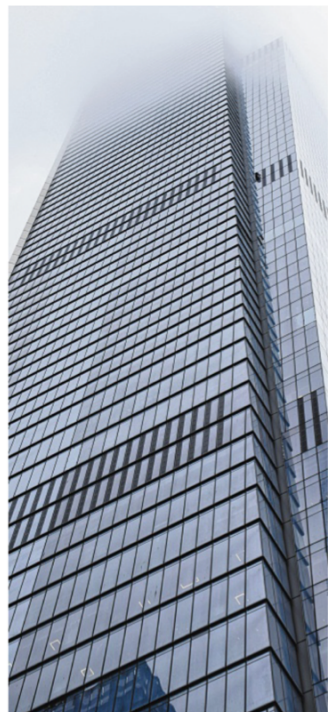
In general, the more senior the position on the capital stack – debt, for example – the less risk and return potential. Debt-based CRE investments tend to mean less risk due to payment priority, contractually obligated rates of return, and shorter terms. The more junior the position in the capital stack – equity, for example – the higher risk and return potential.

Evaluating CRE investment opportunities

The position in the capital stack and the investment style are important parameters in judging the risk/return profile of a given CRE investment. There are four main investment styles with specific risk/return profiles:

■ **Core:** The assets here are stable, cash-flowing properties that are more than 90 per cent leased and generally operating optimally at top-of-market rates. Such properties do not require significant upgrades and tend to be located in primary markets with strong fundamentals. Most returns come from cash flow rather than value appreciation, so Core is among the least risky CRE investment styles. As such, Core investments tend to have longer hold periods and capitalise on the bond-like operational cash flow. Assets are generally conservatively levered, yielding the lowest total return potential, with a 5 per cent to 8 per cent internal rate of return (IRR) range netted out to passive LP investors.

■ **Core Plus:** These properties are usually in primary and secondary markets and are near-sta-



As new demands are created on the built environment, the lines between CRE property types may blur, and new sub-asset classes may emerge. PHOTO: PIXABAY PHOTO: PIXABAY

bilisation in terms of leasing, at or near market rates. To increase occupancy, tenant quality, and rates, Core Plus properties may require light capital expenditure. The strategy is riskier than Core since operational cash flow is more volatile, but it is still a relatively stable and predictable strategy, yielding a total return in the 8 per cent to 12 per cent IRR range.

■ **Value Add:** The assets are located in primary, secondary, and tertiary markets, and expanding to niche asset classes such as hotels and healthcare properties. These properties often lease at large discounts to market rates, providing a mark-to-market opportunity to reset rents during re-leasing. Capital expenditures in the form of major upgrades to both interior and common areas may be needed to compete for renters/tenants, drive rents to market rates, and achieve market occupancy. Value Add relies less on generating steady operational cash flows and more on property appreciation as a key total return driver. Total returns tend to fall in the 10 per cent to 18 per cent IRR range.

■ **Opportunistic:** This investment style sits at

the opposite end of the spectrum from Core. Property appreciation rather than operational cash flow drives performance. Often associated with ground-up development, substantial redevelopment, or a complete repositioning of property, these opportunities are often highly levered or carry significant development or leasing risk. The overall volatility and equity-like nature of this strategy is reflected in its total return profile, which is heavily back-ended or skewed towards the exit of the investment, and generally exceeds a 16 per cent IRR.

The associated return targets of these investment styles may overlap or differ for individual investments. In addition, IRR is subject to timing and cash flow factors, among other influences. For Core and Core-Plus offerings, the focus may be on the cash-on-cash (CoC) return. For value-add and opportunistic investments, IRR and equity multiples may be more relevant.

Finding the right real estate investment

Since the Jobs Act, CRE investment platforms have proliferated. And now that the US economy has weathered two major periods of volatility, the wheat has been separated from the chaff. Only the platforms with stronger track records remain. Different types of private-market CRE investments are available, generally at very low minimums. To select the right investment for their portfolios, investors need to take the following into consideration:

■ **Risk tolerance:** What is the appropriate position in the capital stack and the right business plan relative to their risk/return profile?

■ **Time horizon:** Are they nearing retirement, already retired, or relatively early in their investing journey? That should help determine what CRE investments they choose.

■ **Liquidity needs:** Is the investor pursuing a certain yield/distribution over time? Or are they taking on a different risk-profile and going after a back-ended return or upside at the time of exit? This should influence their strategy selection. What is their hold period? Can they redeem the investment at a time and in an amount of their choosing?

■ **Track record and focus of the CRE investing platform and investment sponsor:** Investors should ask questions to make sure they understand the risks and are comfortable with the associated platform and sponsor. If the client can't get a human to answer their queries, it's a red flag.

As in portfolio construction, diversification is the key for CRE investing. The streamlined, tech-powered nature of CRE investing platforms and low prevailing minimums mean that investors can diversify across platforms, operators, property types, markets, and risk/return profiles.

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