

REITS: REAL ESTATE WITH A RETURN PREMIUM

2015

A Comparison of the Investment Performance of stock exchange-listed REITs and Private Equity Real Estate Funds

Data shows that stock exchange-listed Equity REITs provide not only liquidity and transparency to commercial real estate investors, but also a significant performance premium, on average, compared with private equity real estate funds over long-term holding periods.

Data on REITs and Real Estate Funds

Data from the National Council of Real Estate Investment Fiduciaries (NCREIF) and The Townsend Group, which measure the performance of private equity real estate funds, advance the case for REITs playing a larger role in the total real estate allocations of pension plans and other institutional investors that historically have relied primarily on private equity funds and other direct investment platforms for their real estate allocations.

REITs Outperform Private Equity Real Estate Over the Cycle

While REITs and private equity real estate funds potentially offer investors complementary access to investment in real property, the data show stock exchange-listed Equity REITs, on average, outperformed private equity core, value-added and opportunity funds, on average, over the last full real estate cycle. Over the full market cycle, Equity REITs delivered a compound annual total return, net of fees and expenses, of 13.4 percent – significantly better than the 7.7 percent of core funds; the 8.9 percent of value-added funds; and the 12.9 percent of opportunity funds.

Liquidity Leads the Way

In addition to the performance benefits, REITs also provide the complete liquidity of equities traded on public markets – a major advantage for institutions in managing liabilities, and one that investors in private equity real estate funds find themselves lacking, as has been underlined throughout the financial crisis. At April 30, 2015, the 170 REITs in the FTSE NAREIT All Equity REIT Index had a combined equity market capitalization of nearly \$800 billion and average daily dollar trading volume of more than \$7 billion.

Time to Re-evaluate Real Estate Allocations

The following discussion provides additional detail on a representative comparison of the performance of stock exchange-listed Equity REITs and private equity real estate funds, as well as the reasons for REITs' historical outperformance. Along with their liquidity, transparency, access to capital, and successful, experienced management platforms, NAREIT believes the performance record should be the basis for a constructive review and re-evaluation of the share of REITs in real estate allocations within the portfolios of large institutions.

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Data Point to Need for Better Balance Between Public and Private Real Estate Investment

NAREIT's research team analyzed the performance of stock exchange-listed Equity REITs and private equity real estate funds over the last full real estate market cycle (peak-to-peak) of approximately 17-1/2 years as well as the individual bull market periods (trough-to-peak) for REITs and private equity real estate funds, allowing for the fact that market tops and bottoms reported by the different investment alternatives occurred at different points in time. NAREIT used the FTSE NAREIT Equity REIT Index (an index of 170 U.S. REITs with an aggregate market capitalization of nearly \$800 billion whose constituents manage estimated property assets of more than \$1 trillion) to measure the performance of REITs, and data made available by NCREIF and The Townsend Group to measure the performance of private equity core, value-added and opportunistic real estate funds.

NCREIF-Townsend Indices Measure Fund Performance

The NCREIF-Townsend Fund Indices data incorporated the returns of open-ended diversified core funds (an average of 11 funds with \$25 billion in net limited partner assets during the study period), closed-end value-added funds (averaging 40 funds with \$6.5 billion in assets), and opportunistic funds (averaging 108 funds with \$42 billion in assets). The data were collected by The Townsend Group and published jointly with NCREIF, and are intended to reflect the performance of private equity real estate funds available to U.S. institutional investors.

Downturns Longer for Private Funds

Commercial real estate market cycles typically are approximately 17-18 years long; however, the public and private cycles are not coincident. Public equity markets generally are better informed and more efficient, with investors responding quickly to publicly available information and anticipating future economic and market developments. Consequently, downturns in the cycle may occur more quickly in public markets and may be more prolonged in private markets, which generally are less transparent.

In the last market cycle, REITs experienced a downturn of four quarters, from the third quarter of 1989 through the third quarter of 1990. Private equity funds, by comparison, endured a downturn of nearly three years, from the third quarter of 1990 through the second quarter of

1993 for core and value-added funds, and through the end of 1993 for opportunistic funds.

REITs May Enjoy Longer Bull Markets

Conversely, bull markets may be more extended on the public side. In the last cycle, Equity REITs' 16-1/2 year bull market extended from the third quarter of 1990 through the first quarter of 2007. By comparison, core equity funds had a 15-year bull market from the second quarter of 1993 to the second quarter of 2008; value-added funds had a 14-3/4 year bull market from the second quarter of 1993 to the first quarter of 2008; and opportunistic funds had a 14-year bull run from the fourth quarter of 1993 to the fourth quarter of 2007.

**Over their full cycles,
REITs delivered a
compound annual
total return of 13.4
percent, surpassing
the 12.1 percent
delivered by
opportunity funds.**

During their bull markets, when common wisdom would hold that more heavily leveraged value-added and opportunity funds would deliver stronger returns, REITs again outperformed.

Higher Returns, More Liquidity, and Lower Fees Through REITs

REITs Outperform Over Full Cycle

Over their full cycles, and net of fees and expenses, stock exchange-listed Equity REITs delivered a total return of 802 percent, or 13.4 percent at a compound annual rate, significantly outpacing core funds at 272 percent, or a 7.7 percent annual rate; value-added funds at 348 percent or an 8.9 percent annual rate; and opportunity funds at 716 percent or a 12.9 percent annual rate.

percent for value-added funds and 64 percent for opportunity funds. Core funds generally carry about 20 percent leverage. Since leverage represents risk for investors, REITs delivered superior returns with lower risk, relative to both opportunity and value-added funds.

Illiquidity Premium Doesn't Exist

Still another critical investment attribute is liquidity. Illiquidity is another form of risk, which investors experienced when they were generally unable to dispose of their illiquid private equity fund investments as values dropped precipitously in 2008 and 2009.

Some private equity investors speak of an “illiquidity premium” they believe they receive from locking up their assets in illiquid or comparatively illiquid funds. However, NAREIT’s analysis of private equity real estate’s own reported data reveals these investments earned no premium over fully liquid, publicly traded equity REITs during the last cycle, but instead incurred an appreciable performance penalty.

REIT Fees, Expenses are Lowest

Fees and expenses are another key issue to take into consideration because such costs vary widely among the different investment alternatives. REIT fees and expenses are, by far, the lowest of the group, with institutional investors generally paying about 50 basis points per year for external management of a domestic REIT allocation. By comparison, core funds reported fees and expenses averaging 106 basis points; value-added fund fees and expenses were 168 basis points; and fees and expenses for opportunity funds were 303 basis points.

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Net Returns to Equity REITs and Private Equity Real Estate Funds

	Full Cycle (Peak to Peak)		Bull Market Only (Trough to Peak)	
	Duration	Returns	Duration	Returns
Core Funds (ODCE)	17 ³ / ₄ years 1990q3 - 2008q2	272% 7.7% / yr	15 years 1993q2 - 2008q2	341% 10.4% / yr
Value-Added Funds	12 ¹ / ₂ years 1990q3 - 2008q1	348% 8.9% / yr	17 ³ / ₄ years 1993q2 - 2008q1	464% 12.4% / yr
Opportunistic Funds	17 ¹ / ₄ years 1990q3 - 2007q4	716% 12.9% / yr	14 years 1993q4 - 2007q4	1,104% 19.5% / yr
Equity REITs	17 ¹ / ₂ years 1989q3 - 2007q1	802% 13.4% / yr	16 ¹ / ₂ years 1990q3 - 2007q1	1,041% 15.9% / yr

Source: NAREIT® analysis of data from NCREIF and The Townsend Group, and FTSE NAREIT Equity REITs Index.

Bull Markets Stronger for REITs

During their respective bull markets, when common investment wisdom would hold that more heavily leveraged value-added and opportunity funds would deliver stronger returns, REITs again outperformed value-added private equity funds and nearly equalled the performance of opportunistic funds. Net of fees and expenses, REITs on average delivered a total return of 1,041 percent, or 15.9 percent annually; core funds returned 341 percent, or 10.4 percent annually; value-added funds returned 464 percent, or 12.4 percent annually; and opportunity funds returned 1,104 percent, or 18.4 percent annually, with the higher annualized rate owing to a 2-1/2 year shorter bull market. Comparing annualized (per-year) returns can be misleading when market periods are of different duration, as in this comparison, because annualized returns matter only as long as they can be sustained; the total returns over the entire bull market provide a more valid comparison.

Higher Returns with Lower Leverage

Leverage is a key issue in understanding the significance of the comparative returns, since leverage varies widely among the various investments. REITs carried an estimated 38 percent leverage during the period, compared with a reported average 57

Comparative Leverage, Fees & Expenses

	Leverage	Fees/Expenses
Core Funds (ODCE)	~20%	106 bps
Value-Added Funds	57%	168 bps
Opportunistic Funds	64%	303 bps
Equity REITs	~40%	~50 bps*

Source: NAREIT® analysis of data from NCREIF and The Townsend Group, and FTSE NAREIT Equity REITs Index. *Third-party management of a domestic REIT strategy.

Consequently, over both the last full real estate cycle and the last bull market, REITs delivered better returns than private equity real estate funds with less risk and lower fees.

REIT Model Encourages Strategic Management

While downturns are shorter, bull markets are longer, and fees and expenses are lower for REITs compared with private equity funds, these factors alone still do not appear to wholly explain REITs' performance advantage. The REIT advantage also is attributable to its business model, which encourages REITs to be strategic buyers and sellers of assets.

REITs are *companies*, in business for perpetuity; consequently, their thinking may be more strategic and long-term. Their primary business is managing income-producing properties to generate revenue. They make selective acquisitions when they see opportunities to acquire assets that will generate continuing income for shareholders, and they sell assets when they believe it is necessary and prudent to prune portfolios and better allocate capital to improve ongoing long-term returns.

Disciplined Use of Capital by REITs

Moreover, use of capital is disciplined because REITs are required each year to distribute at least 90 percent of their taxable income as dividends to their shareholders. Thus, capital is not permitted to idly accumulate on balance sheets but must be replenished as needed under the discipline of public debt and equity markets.

Fund Model Presents Portfolio Management Challenges

Closed-end private equity real estate funds, in contrast, are in business for a limited term. They face the challenge of having to find suitable investments quickly to meet their investors' expectations of having their committed capital put to work as soon as possible. Consequently, if they are raising money at or near the top of the market – a common phenomenon – they may be more likely to have to buy property assets at peak valuations. Open-end private equity real estate funds are under similar pressure to invest in response to capital flows rather than market conditions.

Closed-end funds typically sell assets to liquidate them for a scheduled investor payout at a predetermined termination date, while the investment decisions of open-end funds may be similarly constrained by the need to generate cash to meet redemption demands. The need to invest committed capital and sell assets at arbitrary times relative to commercial property market conditions may produce less strategic decision-making on acquisitions and divestitures.

During the property price bubble years, funds were net buyers of \$49 billion of assets; REITs were net sellers of \$86 billion.

REITs Sold Assets in Price Bubble, Funds Bought

This effect can be seen in a comparative analysis of acquisitions and dispositions of assets by stock exchange-listed Equity REITs and private equity funds over the period 2001 through 2010. During the 2001-2005 period, REITs were net buyers of commercial real estate assets, while funds were net sellers. However, during the peak commercial property price bubble years from 2006-2007, funds were net buyers of \$49 billion of properties, while REITs were net sellers of \$86 billion of assets.

REIT Business Model is Liquid, Transparent, Perpetual

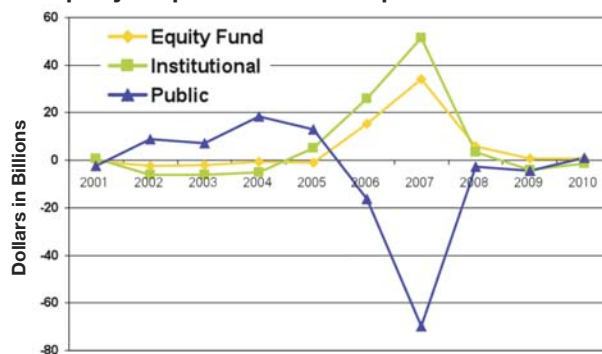
The stock exchange-listed Equity REIT business model – liquid, transparent and perpetual in its perspective – more effectively ensures that managers will buy low, sell high and manage their portfolios well – the ultimate formula for generating superior returns.

More Balanced Public-Private Allocations Needed

Institutions traditionally have heavily favored private equity investment in real estate over REITs, and recent research shows that trend is continuing, in spite of the liquidity problems many institutions experienced with private equity real estate investments over the past two years.

The current analysis indicates publicly traded REITs, with their superior returns, should help institutions more rapidly rebuild value lost during a downturn, as well as provide an invaluable cushion of liquidity against future shocks.

Property Acquisitions Less Dispositions: 2001-2010



Data as of March 31, 2010. Source: Real Capital Analytics and Green Street Advisors

Conclusion: Re-evaluation of REIT and Real Estate Fund Allocations is in Order

Given the performance advantages stock exchange-listed Equity REITs have demonstrated over private equity real estate funds, both over the full market cycle and during bull markets, it is clear that institutions should re-evaluate their real estate allocations to achieve better balance between public and private investment.

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