Real Estate Investment Information

The Five Components of Real Estate Investment Returns

By making direct, private investments in real estate properties, investors are able to participate directly in the economics of the real assets. The following simplified examples illustrate the five different ways that real estate assets can provide investors with investment returns

Cash Flow

Typically, a real estate property generates cash flow to investors by distributing the excess of its rental receipts minus the expenses of operating and owning the property.

A quality real estate property will produce increasing returns over time. Consider a hypothetical property that has $10,000 of rental income, $4,000 of operating expenses, and $5,000 of total mortgage payments. In the first year, cash flow will be $10,000 minus $4,000 minus $5,000 equals $1,000.

Assuming an inflation rate of 2% for both revenues and expenses, in the second year, rental income will be $10,200, operating expenses will be $4,080 and debt service will remain constant at $5,000. Cash flow then will be $10,200 minus $4,080 minus $5,000 equals $1,120. Cash flow therefore increased by $120 (from $1,000 to $1,120) in the second year.

Assuming original ownership equity of $12,500, the first year cash-on-cash return on equity would be the cash flow of $1,000 divided by equity of $12,500 equals 8%. In the second year, the return would rise to cash flow of $1,120 divided by equity of $12,500 equals 9%. The cash-on-cash return increased from 8% to 9% in the second year.

Amortization

The cost of owning a property may include debt service payments for a mortgage. Under the terms of most mortgages, monthly payments remain constant. A portion of each payment is used to reduce mortgage principal, and thereby increase owner's equity. With each payment, the amount allocated to the reduction of outstanding mortgage principal increases and the amount required to pay interest decreases. In the first year of our example, which assumes a 30-year amortization schedule and 7% interest rate, the payments to reduce mortgage principal would be $600 and payments for interest would be $4,400. In the second year, payments to reduce mortgage principal would increase to $700 and interest payments would decline to $4,300.

If ownership equity were $12,500, the first year return on equity related to mortgage principal payments would be $600 divided by $12,500 equals 4.8%. In the second year, the return would rise with principal payments of $700 divided by $12,500 in equity equals 5.6%. This increase in the return from amortization is "built in" to the structure of the mortgage and continues throughout its entire term.

Appreciation

A key measure for the valuation of a real estate property is calculated by dividing net operating income before debt service by a market capitalization rate. In our example, the property has a first year rental income of $10,000 minus $4,000 in operating expenses equals $6,000 net operating income. Dividing net operating income by a capitalization rate of 8%, we get a valuation of $75,000 ($6,000 divided by 8%).

In the second year the rental income is $10,200 minus $4,080 expenses equals $6,120 net operating income. Again dividing net operating income by a capitalization rate of 8%, we get a valuation of $76,500 ($6,120 divided by 8%).

The increase in valuation that occurred because of the increase in cash flow was $1,500 (from $75,000 to $76,500). With ownership equity of $12,500, the gross investment return if the property were sold in the second year would be appreciation of $1,500 divided by equity of $12,500 equals 12%.

Leverage

You may have noticed how the use of leverage in the form of mortgage debt can greatly enhance the returns to the investors.

In our example, cash flow before debt service increased from $6,000 in the first year to $6,120 in the second year, or by 2%. However, cash flow after debt service increased from $1,000 to $1,120, or by 12%.

Likewise, the property value increased from $75,000 to $76,500, or by 2%. However, as previously discussed, ownership equity appreciated by $1,500, the equivalent of a 12% return.

Finally, debt service payments reduced mortgage principal by $700, providing the equivalent return on equity of 5.6%.

Tax Advantages

Tax laws provide favorable treatment to many aspects of direct real estate investments, including tax-advantaged cash flow, reduction of taxable estate valuations and capital gains tax deferral through Section 1031 ("like-kind") property exchanges. The tax advantages of direct real estate investment are covered more fully in Tax Advantages of Private Real Estate Investments. The five components of real estate investment returns can work together in a persistent, cumulative fashion over a period of years to create excellent investment returns.

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Portfolio Diversification Using Private Equity Real Estate

The market portfolio, which includes all assets available for investment and weighted by their natural share of the investment universe, is the ultimate efficient portfolio. Over the long run, an investor who limits his investments to less than the full universe is probably limiting his returns while assuming greater risk than necessary.

The investable universe in the United States is distributed as follows:

Bonds	$16.0 trillion	47%
Stocks	$12.5 trillion	37%
Real Estate	$4.5 trillion	13%
Alternatives	$1.0 trillion	3%
Totals	**$34.0 trillion**	**100%**

The majority (87%) of investment real estate in the United States is owned privately in the form of partnerships, LLC's and privately-held real estate operating companies.

Diversification

The old adage of "not putting your eggs into one basket" applies well to the diversification of investments. Diversification works because the returns from different types of assets move at different rates both positively and negatively. The greatest benefits of diversification are actually achieved when assets move in opposite directions.

Correlation is the degree that two assets tend to move in the same direction, both up and down. Assets are always perfectly correlated with themselves (correlation equal to 1.00) and are partially or negatively correlated with other assets (correlation of less than 1.00). A negative correlation means that the two assets tend to move in opposite directions. The following table shows the correlation among basic asset classes based on quarterly returns between 1978 and 2001.

	Private Real Estate	**S&P 500**	**Lehman Bond**	**Equity REITs**
Private Real Estate	1.00			
S&P 500	-0.05	1.00		
Lehman Bond	-0.14	0.24	1.00	
Equity REITs	-0.02	0.56	0.34	1.00

Because of its negative correlation with stocks and bonds, the addition of private real estate can provide significant diversification benefits to the typical investment portfolio.

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Private Market Benefits

The principal benefits of investing in private markets are diversification, superior risk-adjusted returns, opportunities arising from market inefficiencies and tax advantages.

Diversification: The factors that drive the performance (and volatility) of assets traded in the public markets can be much different from those that influence the performance of private assets. This disconnect was demonstrated quite clearly during the Long Term Capital crisis in 1998, when public markets plunged but returns in private markets were largely unaffected. Likewise, throughout the stock market decline of 2000 to 2003, investments in real estate generally retained their value or appreciated and provided positive returns.

Superior Risk-Adjusted Returns: Investors with long-term investment horizons and portfolios dominated by liquid assets are in an ideal position to be rewarded for providing liquidity to relatively illiquid markets such as private real estate. By being willing and able to make a longer-term investment, they typically invest at a discount to public market valuations, therefore setting the stage for superior risk-adjusted returns.

Market Inefficiencies: Real estate is by its nature a local business. Regions vary in their economic prospects, growth rates, new construction activity, zoning restrictions, etc. There are also a great variety of properties even within each of the major real estate categories (office, apartments, warehouse, retail and hotels). This diversity places a premium on knowledge and information and creates opportunities for investors to benefit from market inefficiencies.

Tax Advantages: Direct investments in private entities owning real estate can provide investors with the pass-through tax benefit of non-cash expenses, such as depreciation and amortization, that shelter cash distributions. These tax benefits result in tax deferred income and enhanced current yields. Also, Limited Partnership and Limited Liability entities generally receive valuation discounts for reduced marketability and management control for estate tax or IRA distribution purposes.

In the future, the probability of subdued stock market performance and a lower interest rate environment will compel investors to search out alternative investment opportunities. An aging U.S. society will create a strong demand for yield and stability from investments. Real estate, by its private market nature, provides both. Moreover, the sheer size of the private markets is too large for investors to ignore. The potential for powerful portfolio diversification benefits provided by private investments will provide investors with an opportunity to enhance their investment performance with both lower risk and higher, more consistent returns.

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The Importance of Management in Private Markets

Management can make a bigger difference in relative investment performance in specialized markets like real estate than in markets for large, widely-followed marketable securities.

The relative performance of various types of investment managers can be broken into quartiles within markets: the top performing 25% of managers comprise the first quartile, the next 25% comprise the second quartile and so on. Looking at the differences in performance between managers ranking in the first quartile and those in the third quartile between 1980 and 1997, we see the following range of results:

Market	Range
Domestic Fixed Income	0.5%
Domestic Equities	1.3%
Foreign Equities	2.1%
Private Real Estate	4.0%

Real estate is by its nature a local business. It is dependent on the selection of specific locations, local economic market conditions, and projections of property supply and tenant demand. Real estate managers and developers must deal with local governments and contractors.

Managers also must attract investment capital and arrange for debt financing, often tapping into regional, national and even international sources. They must market and rent the property, manage maintenance and capital expenditures and comply with a wide range of regulatory requirements.

Finally, the real estate investment manager must provide accurate and timely reporting on the results of operations to investors and to local, state and federal tax entities. When the time comes to sell the property, the manager must orchestrate the disposition process to a successful conclusion.

An investor should expect the following from a real estate investment manager:

- Careful screening and selection of opportunities
- Ability to obtain value at the time of acquisition
- Stringent due diligence standards and practices
- Financing expertise
- Property management expertise (systems, operations, experience)
- Professional accounting, financial management and reporting

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Tax Advantages of Private Real Estate Investments

Investors who must pay taxes know that their investment returns are often diminished after they pay taxes on dividends, interest and capital gains. Estate taxes may further reduce the amount of wealth they are able to leave to their heirs.

Direct, private real estate investments can receive beneficial tax treatment in a number of ways. Following is a general overview of three of the situations under which direct real estate investors may receive tax benefits. As with any tax issue, an investor should consult with his or her personal professional tax advisor regarding his or her specific circumstances.

Tax Advantaged Cash Flow

The private partnership structure allows the distribution of tax losses to investors and the resulting enhancement of after-tax returns. The resulting after-tax cash yield can be equivalent to a taxable return that is significantly higher. For example, for a taxpayer in the highest New York state tax bracket, a tax-advantaged 7% cash on cash return can be the equivalent of a 12.5% taxable return.

Referring to the example illustrated under the topic "The Five Components of Real Estate Investment Returns," our hypothetical property has $10,000 of rental income, $4,000 of operating expenses, and $5,000 of total debt service. In the first year, cash flow will be $10,000 minus $4,000 minus $5,000 equals $1,000.

For tax purposes, we can deduct only the interest portion of debt service ($4,400). However, we can also deduct $2,700 in depreciation expense, which is a non-cash item. Our tax income is therefore $10,000 minus $4,000 minus $4,400 minus $2,700 equals a loss of $1,100. Because the tax return shows a loss, no taxes are due in the current year. As result, the cash flow in the amount of $1,000 that was distributed to investors would not be taxed.

For a passive, limited partner investor, the IRS categorizes this type of loss as a passive loss that can be applied against other passive income. If the investor does not have other current passive income against which he can apply the current passive loss generated by a particular investment, he may carry the loss forward as a credit for use in future tax years. Typically, passive losses are highest in the early years of a real estate investment when depreciation expenses tend to be higher. As the property increases its revenues and income, passive losses tend to decline and eventually turn into passive income. However, by utilizing accumulated passive losses from prior years to shield current year income, an investor extends the period during which he receives tax-sheltered cash flow. Even after the accumulated passive losses run out, tax income may continue to be only a fraction of actual cash distributions, so that the investors’ cash flow continues to be tax advantaged.

Reduction of Taxable Estate Valuations

Despite recent changes in the tax laws, estate taxes remain a concern for high net worth individuals. Over time, recent changes to the tax code will raise the Applicable Exclusion amount, which is the amount that may be passed along to one’s heirs tax-free. However, the marginal tax rate applied to the value of estate assets that is in excess of the Applicable Exclusion amount will remain very high, in the range of 45% to 50%.

The ability to effectively "shrink" the size of an estate for tax purposes can result in lower estate taxes, increasing the wealth passed along to one's heirs. Subject to the provisions contained in a specific Limited Partnership Agreement, assets held in the form of limited partnership units may qualify for "minority interest" and "non-marketability" discounts that may reduce their valuation for estate tax purposes by 45% or more.

For illustration purposes, let's assume the 2004-2005 Applicable Exclusion amount of $1,500,000 and an estate size of $1,750,000 with investments entirely in the form of stocks and bonds. The amount over the Applicable Exclusion amount of $1,500,000, or $250,000, would be exposed to the marginal estate tax. A marginal tax rate of approximately 50% times $250,000 equals $125,000 in taxes. The total real value of the estate passed on to heirs would therefore be reduced by the requirement to pay estate taxes of $125,000, from $1,750,000 to $1,625,000.

However, if the estate in our example were instead comprised of $500,000 in the form of limited partnership interests and the remainder in stocks and bonds, and assuming one could apply a 50% discount to the limited partnership interests, the value placed on the limited partnership interest would be reduced from $500,000 to $250,000 for estate tax purposes. The taxable estate therefore would be reduced from $1,750,000 to $1,500,000. No estate tax would be due since there is no excess over the Applicable Exclusion amount of $1,500,000. The total real value of the estate's assets would remain $1,750,000. The tax savings of $125,000 would be retained within the estate and passed along to heirs.

Section 1031 Exchanges

Investors who own real property for business or investment purposes may face significant capital gains taxes when they sell their property. However, it is possible for them to defer the payment of capital gains taxes by "rolling over" their investment through an exchange for another property that is of "like kind." Exchanges of real properties qualify even if they are dissimilar. A factory property can be exchanged for an apartment complex. The exchange does not have to occur simultaneously as long as it is completed in a specified time period. The investor must identify a replacement property within 45 days of closing on the sale of his original property and he must receive ownership of the exchange property within 180 days. Upon completing the exchange, the investor's tax basis in the original property is carried over to the replacement property. The capital gains tax bill is deferred until the exchange property is sold. However, no capital gains tax would be due if the investor conducted another Section 1031 exchange instead of selling the property. And of course, no capital gains tax would be due if the investors ownership interest became part of his estate upon his death.

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What's Wrong with REIT's

A Little History
The REIT structure was created in 1960 through the Internal Revenue Service tax code to provide a means for small investors to participate in the ownership of real estate. REITs are public companies that invest at least 75% of their assets in real estate property and pass through to their shareholders 90% of their earnings, as well as any capital gains generated from the sale of properties. A REIT does not have to pay taxes on its earnings, but the dividend income received by investors is taxed as ordinary income.

Performance Issues
From 1985 to 2000, REITs delivered an average income return of 8.9% that was reduced by share price losses of -1.7% for a total return of 7.2%. From 1990 to 2000, the yield on REIT stocks had an average spread of just 83 basis points (0.83%) over the yield on 10-year treasury securities *(1)*. These returns, which do not include stock transaction costs, do not appear to compensate investors for the additional volatility-related risk they assume by investing in REITs.

REITs have some structural handicaps that contribute to this poor risk-adjusted performance.

- First, the market requires investors that invest in REITs to pay a premium for the attributes of liquidity, securitization and diversification. This may partially explain why REITs have historically traded at an average premium of 1.8% over their net asset values.
- Second, studies have shown that in acquiring properties, REITs pay approximately 6.6% more compared to prices paid by private investors for comparable properties *(2)*. At Benchmark, we can attest to losing numerous property acquisition opportunities to REITs and their "win without regard to cost" approach *(3)*. We also can attest to the relatively casual approach most REITs take to performing due diligence on properties being acquired.
- Third, REITs tend to be short term holders of properties (3 to 5 years), churning their property portfolios and eroding returns as they incur real estate transaction costs of 3% or more.
- Fourth, REITs are required to invest only 75% of their capital in real estate properties, leaving 25% to invest in other service businesses. During the late 1990's, many REITs sought to join in the technology boom by investing in new technology-related businesses such as computer software and broadband services instead of real estate.

Irrational Volatility
Many REITs took advantage of depressed real estate market conditions in the early 1990's. In a period that included the S&L debacle and an economic recession, they acquired properties at a deep discount to their long term values, many from the Resolution Trust Corporation. With an improving economy and declining interest rates over the next six years (1990-1996), REITs benefited as the entire real estate sector posted strong returns. Enthusiastic Wall Street analysts proceeded to categorize REITs as growth stocks. With an increase in share prices by the third quarter of 1996, REITs were trading at an average premium of 37% over the value of their underlying assets.

As it became clear that these high valuations were untenable with respect to actual long term earnings growth, large numbers of "growth" investors dumped their REIT stocks in favor of the next great growth play, technology stocks. By the second quarter of 1998, REITs were trading at a 19% discount to their net asset values. During 1998 and 1999, REITs' returns turned negative. Their share prices declined an average of 37% *(4)*. Total returns, including dividends, declined by 25%. During 2000 and 2001, as investors fled the rapidly collapsing technology bubble, the pendulum swung back in favor of REITs. Their share prices rose 16% and their total returns including dividends increased 32% over the two-year period.

Remarkably, these wide swings in REIT stock prices and total returns have occurred without apparent regard to the relatively stable 4.2% growth rate of the net asset values of the properties they owned. The public market has proven to be an inefficient mechanism for pricing the equity value of real estate property. Real estate value is best calculated by discounting the present and future income streams generated by actual real estate holdings.

What About Shareholders?

REIT managers are under pressure to produce continually increasing quarterly earnings per share to attract "non-dedicated" investors. This short-term focus does not permit them to manage the properties they own for the long run. Worse, with at least 90% of their income paid out as dividends, REITs are challenged to generate enough capital internally to add properties to their portfolios.

Management's desire to "build an empire" can hurt the interests of shareholders. Recall that during the period 1997 to 2000, REIT stock sold at significant discounts to net asset values. Under these conditions, shareholders would have been best served if REITs had used surplus cash to re-purchase shares. Instead, REITs spent $29 billion to acquire new properties, added $63 billion in debt to their balance sheets (increasing their debt to market capitalization ratio from 34% to over 50%), engaged in off balance sheet joint ventures (adding still more debt) and issued a net amount of $45 billion in <u>new</u> stock *(5)*. Shareholders were left with riskier, more highly leveraged investments and diluted ownership positions. Predictably, share prices declined.

How Liquid?

REITs are not as liquid as they might appear. They are thinly-traded small stocks whose liquidity is further reduced by a concentration of stock ownership. Up to 50% of a REIT's stock may be held by board members who contributed properties to the REIT in an exchange for shares. Studies of REITs reveal declining returns with increasing insider ownership because of conflicts of interests. *(6)* Further, founding board members typically have a low tax basis and large unrealized tax liabilities that freeze them from selling their stock. Large institutional investors hold approximately 50% of all REIT stock outstanding. While only large institutional investors would encounter a market liquidity gap in selling off their positions, all investors can encounter increased bid/ask spreads and therefore higher trading costs.

Declining Economies of Scale

By its nature real estate is "fixed in place" and therefore is a locally-managed business. There is no evidence that REITs have been able to either demonstrate superior management expertise or achieve economies of scale compared to private firms. In fact, there is evidence of diseconomies of scale. As REIT size increases, management tends to focus more on new business and stock market issues and less on the original purpose of the business, real estate. *(7)*

At one point during the 1990's, bullish analysts predicted that REITs would soon own most of the investment grade real estate in the United States. Given all their handicaps, it is not surprising that REITs' share of all property types actually declined by approximately 6% between 1999 and 2000 and remains at about 13% of all real estate held for investment.

Stock, Bond or Real Estate?

Given the market-related volatility of their stock prices and returns that are remarkably uncorrelated to the net asset values of their real estate properties, a legitimate question is whether REITs are more like stocks, bonds or real estate. It appears that most "non-dedicated" investors are yield driven and not focused on asset values, so to them REITs are more like a bond. Most large institutional investors, who also make direct real estate investments, classify their REIT holdings as stocks, not real estate. In fact, REIT returns are most highly correlated with the Utility Sector of the stock market.

The entire REIT stock universe includes 178 public companies with a total market capitalization of approximately $250 billion, which is about three quarters the size of General Electric. With an average market capitalization of $1.4 billion, REITs are classified by Morningstar as small capitalization stocks.

If an investor is truly committed to adding real estate to his or her portfolio, we think it makes more sense to invest directly in real estate rather than in REIT stock.

- Real estate is under-represented in most investment portfolios. It is a long-term asset that performs best when held long term. It merits and rewards an investor's commitment to it.
- REIT investors pay a premium for stock in a company that in turn pays a premium to own real estate properties. With private investments an investor has direct ownership in the real estate property without the inefficiencies of intervening structures and negative consequences of a short-term management focus.
- Returns from private real estate are less volatile, and therefore less risky than those of REITs, since they do not have a share price component that is tied to the emotions and fads of the public markets.
- Private investors participate directly in a property's cash flow and the regular, increasing equity returns from the amortization of mortgage principal as well as the appreciation in property value that occurs as property cash flows increase over time. REIT investors can only hope that price movements in public markets will reflect underlying fundamentals and provide them with these investment returns.
- With a negative correlation to the returns of stocks and bonds, private equity provides investors with a superior portfolio diversification benefit. By contrast, REIT returns have positive correlations with stocks and bonds and therefore do not provide as much portfolio diversification benefit. *(8)*
- Private real estate provides a hedge against inflation and therefore does a better job of preserving capital. Private real estate returns have a positive correlation with the consumer price index. Returns from REITs have a negative correlation. Private real estate returns are likely to increase with inflation. REIT returns are more likely to decrease.
- The private partnership structure allows the distribution of tax losses to investors and the resulting enhancement of after-tax returns. The resulting after-tax cash yield can be equivalent to a taxable return that is significantly higher. For a taxpayer in

the highest tax bracket, a tax-advantaged 7% cash on cash return can be the equivalent of a 12.5% taxable return.

- Direct equity investments provide a superior ratio of reward to risk with higher after tax returns and without the risk of stock market related volatility. The risk-adjusted performance of private real estate is superior not only to that of REITs but also to that of all other publicly traded securities.

(1) "Investing in REITs," National Association of Real Estate Investment Trusts, November, 2000.
(2) "As the Nineties End, Market Leadership Rotates," Pension Real Estate Association Quarterly, Fall, 1999
(3) After one live auction we attended in Tennessee in the mid-1990's, a representative from the victorious REIT actually handed out business cards while proclaiming "We pay the highest prices!"
(4) REIT Watch, National Association of Real Estate Investment Trusts, November, 2000
(5) Green Street Advisors, Inc., October 10, 2000
(6) "Insider Ownership and REIT Performance – Is More Always Better?" Prudential Real Estate Advisors, December, 2001
(7)"REITS' Share Falls as REIT Shares Rise," Prudential Real Estate Investors, July, 2001
(8) Real Estate Finance and Investments, William B. Brueggeman and Jeffrey D. Fisher, McGraw Hill, 1997.

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