Wealthy Families See Attractive Opportunities in Commercial Real Estate

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Institutional capital has been pouring into the commercial real estate sector recently, helping push investment sales volumes up each year since the downturn. But it's another pool of capital—funds from high net worth individuals and family offices—that may drive the next wave of investment.

Dani Evanson, managing director with RMA, a California-based real estate investment and advisory firm that caters to family offices and wealth management firms, believes that the increase in the amount of private capital allocated to the sector in 2014 will push volumes to new heights. Starting in 2012, Evanson's firm began getting phone calls from both new clients looking to bet on commercial properties and existing clients wanting to increase their real estate allocations significantly.

As a prime example of the interest from high net worth investors, Evanson points to a family office with $1 billion in holdings that prior to 2012 had 7 percent of its wealth invested in real estate. In 2013 that figure jumped to 10 percent. "That's a very large increase, when you are talking about a $1 billion family office and an increase of 3 percent," she says. "The vast majority of our clients have increased their allocations to commercial real estate since 2012."

Overall, the amount of capital RMA has under management has jumped from a little more than $800 million in 2007 to $1 billion today, an increase of 25 percent. That reflects a broader trend in wealthy private investors' view of real estate. A survey completed this February by Morgan Stanley's wealth management unit found that 77 percent of investors with $100,000 or more in assets now have a direct stake in real estate properties, while another 34 percent own REIT stocks. That makes real estate the most popular alternative asset class out there, with only 34 percent of surveyed investors owning the next most popular alternative asset, collectibles.

Real property and REIT stocks were also the alternative assets wealthy investors said they are most likely to buy in 2014, at 33 percent and 23 percent of survey respondents respectively. (The survey included 1,004 investors between the ages of 25 and 75. About a third of these investors own $1 million or more in assets, according to Morgan Stanley.)

Last month, for example, RMA gained a brand new client, a high net worth investor whose entire portfolio was previously tied up in equity stocks and bonds. But seeing very little yield from those investments the client decided to allocate 5 percent of his holdings to an illiquid real estate portfolio.

"That's a major shift in thinking to go from purely liquid to illiquid allocations," Evanson says. The client "just said that in 2014 and beyond, [they] see a negative return in [their] bond portfolio and believe that real estate may serve as an alternative and get the yield that [they] need."

Real Capital Analytics (RCA), a New York City–based research firm, estimates that in 2013 private investors, including high net worth individuals, bought $144.4 billion in commercial real estate properties, an increase of roughly 18 percent from 2012. The last time private investment in real estate was that strong was in 2007, at $187.3 billion.

In contrast, institutional equity funds spent $84 billion on commercial real estate acquisitions last year, about the same amount as in 2012, RCA reports. Listed REITs bought $65.6 billion worth of properties and cross-border investors $35.2 billion.

In RMA's experience, most family offices and high-net investors currently belong in either of two strategy camps. There are the clients who are looking for cash-flowing, low-risk properties, including multifamily buildings, assisted-living facilities, net leased industrial properties and first mortgage debt. Last September, for those kinds of investors, RMA formed RMA Northbridge Assisted Living Fund LP, a $100 million closed-end fund with the goal of buying and developing $250 million worth of assisted living and memory care facilities in New England.

Then there are clients looking for value-add, high-return investments, which in RMA's case may take the form of ground-up development projects, turnaround opportunities in the office sector, retail, hotel and industrial assets and student housing.

There's virtually no crossover between the two schools of thought, with most clients either wanting the entirety of their real estate allocations tied up in cash-flowing assets or high-yield investments, Evanson says. When talking about high yields, clients envision something in the range of 12 percent to 15 percent, she notes, which means the assets have to be positioned in primary and secondary markets. About 21 percent of RMA's portfolio is located in the Northeast, primarily in New York, Washington, D.C., and Boston, followed by 19 percent of allocations outside the United States, 10 percent in Northern California and 9 percent in secondary U.S. markets.

Another emerging trend is multiple family offices partnering on a single investment, generally known as club deals. Recently eight of RMA's clients have put their money into a development deal in Los Angeles that comes with a nominal amount of cash flow from an existing building on the land. "Obviously there is risk associated with the development, so the clients needed to be willing to take on the risk," Evanston explains. "And all of the clients fit that profile and all eight went into the transaction."

Today, the largest chunk of RMA's portfolio (28 percent) is dedicated to rental multifamily properties, followed by offices (18 percent) and retail (12 percent.) Land development (3 percent) and self-storage (1 percent) make up the smallest slice of its investments.

Pulling together

Clubbing is also the investment model offered by the FORE Partnership, a London-based direct co-investment in real estate program for family offices from around the globe. According to Basil Demeroutis, managing partner, wealthy families have always known the value of real estate—"It predates almost any other asset class you can think of, even currency itself," he says. What's changed today is that they want to own direct stakes in operating bricks-and-mortar properties, as opposed to more complicated products such as commercial mortgage bonds. That's a lesson many learned during the global financial crisis.

"The further they got from bricks and mortars into operating assets, like investing in ski resorts, they more they got burned," Demeroutis says. "So our families want bricks-and-mortar. Whatever form that may take—some mispriced income—it may also come to them in something that's vacant in a small town in a central city location. I think they are fairly agnostic, pretty opportunistic minded. And that's one of the key differences between families and institutional investors. Institutional investors have defined boundaries, they are very prescriptive. The families we deal with are at the opposite end of the spectrum, they are incredibly nimble."

Like Evanson, Demeroutis believes that family offices and high net worth investors will become the "hedge funds" of the next decade in their impact on the marketplace. One of the greatest challenges they face when it comes to commercial real estate investment, however, is finding appropriate deals. Even with all the advantages that clubbing offers, last year FORE looked into 1,082 potential transactions. It closed on four.

Demeroutis and his partners set up FORE in 2011. He first honed his skills in commercial real estate investment while working in the investment banking department of Bear Stearns in the late 1990s, followed by running a real estate fund in Germany that acquired multifamily and office assets, and later in-house at a large multibillion-dollar single-family office.

FORE's investments last year included a vacant office building in London overlooking the Thames that will be turned into a 47,000-sq.-ft. class-A property; a fully occupied building in Aberdeen with a long-term lease to British Telecom; two retail properties in a sub-market of London and a post office in West Berlin that will be converted into a 110,000-sq.-ft. multifamily building.

"We look at a lot of deals and I think getting access to good deals is one of the things our families struggle with," Demeroutis says. "Unless you are in the market day in and day out, accessing [it], talking to agents and landlords, it's actually hard to find great deals. And that's the beauty of our platform. We are a shared asset, a virtual in-house property team."

The FORE Partnership currently owns no properties in the United States, partly because its partners lack previous experience in the marketplace, but also because they believe that commercial real estate values stateside have shot up too much. In Europe, where economic recovery has trailed the United States by at least a year and a half, there's still attractive pricing to be found.

To date, FORE has invested €100 million in club deals, seeking internal rates of returns of 12 percent to 15 percent. The group has a preference for prime locations, but that definition varies depending on specific opportunities, according to Demeroutis.

"A building may be in a B city, but as long as it's in the CBD, for us that can still qualify as an A location," he says. "For example, Leeds may not be on every investor's list, but it's on our list so long as we can get a good center city location.

"We like office, we like retail and we like multifamily," he adds. "We think those three sectors offer the most compelling risk-adjusted returns right now."

Managing risks

David A. Cohen, co-founder of Karlin Real Estate, an affiliate of Karlin Asset Management that invests in commercial real estate in the U.S. and Canada, prefers his group remain autonomous rather than co-investing

with other family offices. “I think they are a great idea, but we really like to control our own destiny,” he says.

Cohen cut his teeth in the commercial real estate sector during the Resolution Trust Corp. days of the early 1990s. Having seen how much money some entrepreneurs made buying distressed assets from banks, he was eager to set up a company that could take advantage of the looming real estate disaster in the mid-2000s. The 2006 deal in which Tishman Speyer and BlackRock agreed to pay $5.4 billion for the Stuyvesant Town-Peter Cooper Village residential complex in Manhattan was the signal he needed to start looking for specialists in the field of distressed real estate.

“As I looked at the pricing of that deal, it [seemed] like we were in a pricing bubble,” he says. “So I went around looking for a team when there was really no distressed real estate. We ultimately hired our first team member in 2008.”

As it turned out, the banks learned something from the RTC era as well, and that was not to give away valuable assets away for cents on the dollar. The flood of distressed opportunities that was expected never materialized. But by staying patient and developing relationships with financial institutions Karlin was able to benefit from the smaller, more complex deals the banks did want off their books. During the depth of the financial crisis, those deals took the form of loan and note sales. In more recent years, Karlin has moved on to direct property investment.

Unlike many institutional investors, Karlin skipped over primary markets from the beginning of the real estate recovery, believing that property values in those markets were too high. Instead, the group focused on secondary cities, including Denver, Phoenix, Las Vegas, Orlando, Tampa and Sacramento.

“Culturally, we are very risk averse,” Cohen says. “And our feeling was that there was a tremendous yield spread between primary cities and secondary cities. In secondary cities, we could build in lots of flexibility [into our deals] and have more protection. The [assets] were very cheap and there was not a lot of buyers. And especinally with notes and loans, we really had very little competition. And we never got comfortable with valuations in the primary markets. We did just as well, if not better, in secondary markets and felt like we had downside protection.”

An example of a deal Karlin may get involved in is a vacant office building in a secondary city. The property fundamentals in the area may be strong, but the original owner may have walked away from the asset because he couldn’t charge high enough rents to pay down the mortgage assumed during the boom. Since Karlin may be buying the mortgage for 50 cents on the dollar, it has the resources to invest in tenant improvements and to get the same building fully occupied within 90 days, Cohen says.

Outside of the geographic focus on secondary cities, the assets Karlin has invested in span the sectors, from office and retail to multifamily and industrial. Over the past five years, the group has participated in more than 50 transactions totaling approximately $750 million. But the pace of its acquisitions has slowed significantly since 2012, Cohen says, not for lack of interest, but because it’s been harder to source attractive deals. That’s partly why Karlin has set its sights on Europe, closing four deals in secondary cities in the U.K. and currently reviewing available assets in Spain, one of Europe’s hardest-hit property markets.

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A recent survey of high net worth investors by the Investment Program Association (IPA) found that such investors believe commercial real estate is currently a more attractive asset class than equities.

The survey, which included 500 individuals aged 35 and older with annual household incomes of $150,000 and more and net investable assets of $250,000 or more, was administered in February. IPA researchers found that approximately 83 percent of survey respondents currently believe that commercial real estate assets will post a better performance over the next five years than the equity market.

Another 35 percent said they were familiar with investing in non-traded REITs—an increase of 600 basis points from the 29 percent who reported such familiarity just last March.

About one third, or 32 percent, currently hold investments in non-traded REITs, with allocations ranging from approximately 1 percent to 5 percent of invested income.

"Investors see tremendous value," in commercial real estate products, says Kevin Hogan, president and CEO of IPA. "There are several reasons for that. One, the products are performing. And you add that to the fact that the fundamentals in our industry today are [improving]—office occupancy rates are up, retail occupancies are up—there is just continued demand for real estate and growth. It just seems like the perfect storm."

— E.M.

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