Do "Opportunistic" Real Estate Partnerships Add Value?

Do private opportunistic real estate partnerships add value above a diversified portfolio of direct core property holdings? This is a question that institutional investors may ask themselves as they decide how to allocate dollars within their real estate allocation. Our analysis suggests that the answer is yes, finding that private opportunistic real estate partnerships produced annualized excess returns of 5.4% over direct core property holdings, represented by the NCREIF Property Index, over the June 1992 to June 2007 time frame.

Real estate allocations by large institutional investors have historically been represented by diversified direct core property holdings invested through commingled and separate accounts. The vast majority of holdings would be trophy quality, high income producing properties with little or no leverage. In the late 1970s the NCREIF Equity Index was created to measure the performance of this conservative real estate strategy. In the early 1990s a new type of real estate strategy emerged from the distressed real estate environment following the S&L crisis. This has become known as "opportunistic" real estate investing and is akin to private equity where investors' assets are pooled through a limited partnership vehicle with a finite life with strong incentives for the general partner (manager) to invest capital and realize returns over a five to seven year horizon. Unlike the traditional core real estate structures, partnership investments are likely to involve higher levels of leverage (60-80%), invest overseas, participate in developmental or major renovation, and partner with local experts.

Exhibit 1: Net IRR of Private Opportunistic Real Estate Partnerships versus the NCREIF Index
June 1992 to June 2007

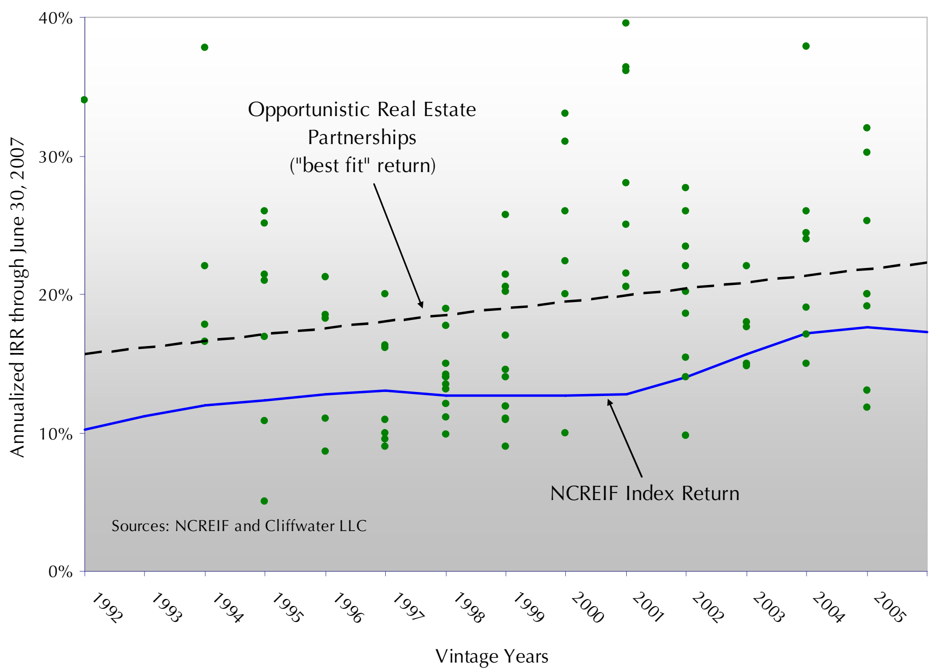

Exhibit 1 plots returns through June 30, 2007 for 90 opportunistic private real estate partnerships (37 managers) by vintage year. Returns are IRRs, or internal rates of return, from inception of each partnership and are net of all fees. The dashed line represents the "line of best fit" for all 90 partnerships and can be interpreted as what the average opportunistic real estate partnership produced over time. The lower solid line shows the NCREIF Property Index performance by vintage year through June 2007. For example, the 1992 vintage return of 10% for the NCREIF Index is its annualized return from June 1992 to June 2007. The difference between the dashed line and the solid line represents the excess return from private real estate partnerships over the NCREIF Index, which has averaged 5.4% over the 15 year time period.

The 5.4% average excess return hides some significant variation in partnership performance over time. For instance, opportunistic real estate partnerships during the 1997-1999 vintage years produced returns lower than their counterparts in other vintage years. This underperformance is largely attributable to real estate investments in geographic areas with heavy concentrations in telecom businesses, which were hurt during the Internet collapse.

In addition to variability in partnership performance over time, there is considerable variability in partnership performance within any vintage year. This is characteristic of most inefficient markets and implies that manager/partnership selection is very important. For real estate partnerships the average difference between a first quartile return and a third quartile return within the same vintage year is 8.5%, a magnitude of dispersion that would rank real estate partnerships between hedge funds (5.4%) and buyout funds (16.4%) in the importance of selection.

Although real estate general partners are not identified in Exhibit 1, several general partners (managers) have shown consistently strong returns across vintage years. However, the very top performers by vintage year tend to vary and are characterized by partnerships whose investment strategy is property sector or geographically focused.

Our study has limitations. First, there is selection bias as sample data rather than the entire universe of opportunistic managers is used. In general, top performing funds are more likely to provide return data while average and underperforming funds are not. Second, a small portion of real estate partnership returns have reporting dates prior to June 2007, though we do not believe the effect of this is significant.

In summary, opportunistic real estate partnerships have historically added significant (5.4% annually) value over the NCREIF Property Index, equivalent to excess returns produced by private equity partnerships over publicly traded stocks. Second, the wide dispersion in vintage year fund performance, similar to private equity, indicates that real estate manager selection is important. Third, since some vintage years have performed better than others, diversification by vintage year is recommended. Lastly, investors should look for managers that demonstrate consistently strong returns across multiple vintage years.

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