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The Investors Have Left the Building

Following several years of strong performance and rapid asset-gathering, at least two of the world's largest non-traded real estate investment trusts (REITs) have "gated" redemptions as their investors start heading for the exits.

Ironically, the redemptions may be coming in part because of strong performance—especially relative to the declining prices of publicly traded REITs in 2022.

In this article, we ask: are the investors redeeming from non-traded REITs being tempted not only by a relative-value opportunity in public REITs, but also by the potential for public REITs themselves to buy quality assets, at a discount, from their private peers?

What Happened Late Last Year?

Non-traded REITs used to be an unliked backwater of the real estate world. Next to publicly listed REITs, they seemed to offer only high fees, high leverage, conflicts of interest and lackluster performance.

Over recent years, however, some well-established and highly respected private equity businesses entered the arena, attracted by the perpetual fee streams and the ability to sell funds, typically allowing monthly redemptions, to individual investors. Many have delivered strong performance, which led to rapid asset-raising.

According to Stanger Investment Banking, non-traded REITs raised almost $12bn in 2019 and almost $11bn in 2020. In 2021, Blackstone Group's BREIT fund alone raised just short of $25bn. Real estate research firm Green Street estimates that, at the peak of fundraising in the fourth quarter of 2021, non-traded REITs were taking in astonishing net flows of $4bn per month.

By the end of November 2022, however, Wolfe Research estimates the sector's net flows to have been negative. Indeed, redemption notices have been coming in so thick and fast that the two largest non-traded REITs, Blackstone's BREIT and Starwood Capital's SREIT, exercised their right to limit them.

Most non-traded REITs have "gates" that limit redemptions to 2% of net asset value (NAV) per month or 5% of NAV per quarter. Real estate is an illiquid asset class, and these gates are designed to prevent disorderly exits from fund vehicles and the potential resulting "fire sale" of assets, in order to protect those investors who wish to stay committed.

Relative Value in Public REITs

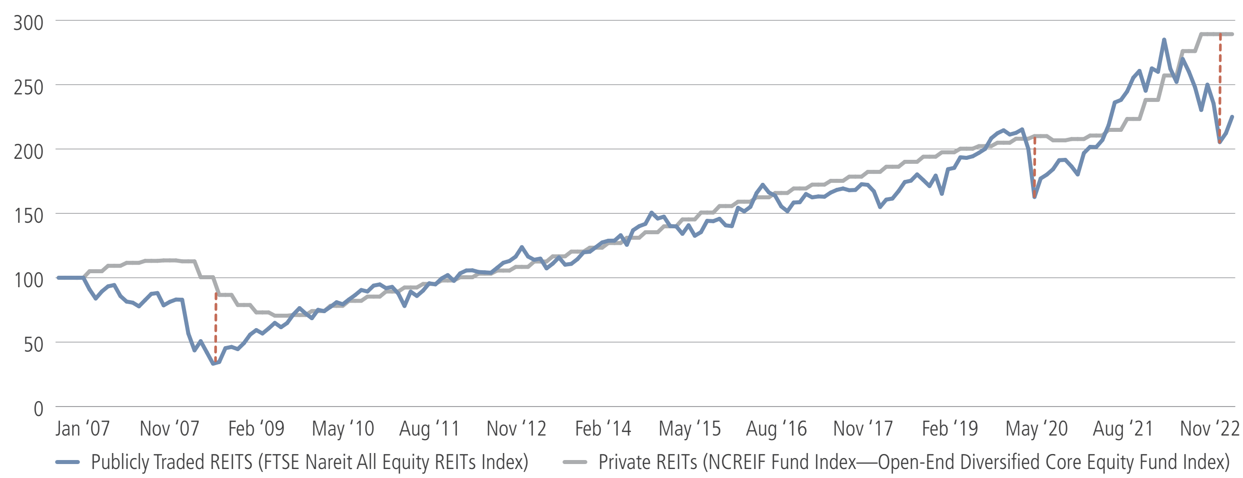
The values of private real estate and non-traded REITs have started to come down, but it might be the reported *strength* of private real estate funds and non-traded REITs during 2022—rather than recent weakness—that's partly to blame for the outflows.

The NCREIF Fund Index—Open-End Diversified Core Equity Fund Index (NCREIF—ODCE), which tracks the performance of a select number of private real estate funds, was up 13% for 2022 to the end of October, according to NCREIF. By contrast, the benchmark for publicly traded REITs, the FTSE NAREIT All Equity REITs Index (FTSE NAREIT), was down 25.5%, according to FTSE Russell.

This is not an unusual pattern in a downturn, as figure 1 suggests. The underlying NAVs of publicly traded REITs generally exhibit a similar smoothness as those of private real estate. And over the long term, according to NAREIT's calculations, public REITs and private real estate funds have delivered compound annual growth rates of approximately 12% and 8%, respectively, while the correlation of their returns, accounting for lags, has been 0.91.

That is unsurprising, given that the assets underlying the two different types of investment structure are very similar. Over the short term, however, the market can express a view on underlying asset valuations via the stock prices of public REITs—and in down markets, those public REITs stock prices have tended to decline faster and further than private real estate fund NAVs, before quickly re-converging.

FIGURE 1. PUBLIC VERSUS PRIVATE REAL ESTATE



Source: Bloomberg. Data as of November 30, 2022. Indices re-based to 100 at January 31, 2007. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Green Street estimates that, by the end of November, U.S. commercial real estate valuations were down 13% from their peaks, on average, with at least another 5% to come.

Given that outlook, the 25% drawdown for public REITs starts to look like an attractive value opportunity—particularly as public REITs tend, on average, to run with less leverage than private real estate funds. Moreover, public REITs currently trade at a discount of roughly 20% below net asset value (NAV), on average. Over the years, from that starting point REITS have tended to generate attractive total returns.

FIGURE 2. PUBLIC REITS ARE TRADING AT NOTABLE DISCOUNTS

U.S.-listed companies, Green Street weighted average premium/discount to net asset value

Source: Green Street. The chart shows the average discount/premium to net asset value, weighted by net asset value multiplied by shares outstanding, of all US-listed companies in Green Street's coverage universe, excluding Hotels and those without a published opinion; the average is equally weighted prior to January 1993. Data as of November 1, 2022. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

At the moment, anecdotal evidence that we see suggests that most of the redemptions coming out of non-traded REITs are going into cash. Some of that might be investors tactically rotating out of the real estate asset class altogether as we enter an economic downturn. However, we think it's likely that a meaningful portion is earmarked as a strategic allocation to real estate, now looking to rotate into more attractively valued opportunities within the asset class. Might a sizable amount of that cash ultimately be headed for public REITs in search of the substantial discounts to non-traded REIT NAVs currently on offer?

A Potential Value Opportunity *for* REITs as well as *in* REITs

Attractively valued public REITs are potentially just the start of this story.

There is no immediate reason to anticipate that non-traded REITs will be forced into a "fire sale" of their underlying assets. That, after all, is what their redemption gates are designed to prevent. Liquidity can be obtained from other sources: the funds could take on more debt, adjust or cancel any planned share repurchases or sell liquid assets they may hold, such as public REIT equity securities or real estate debt.

For example, JPMorgan estimates that, having realized around $1.3bn from one real estate asset sale, the BREIT fund has enough cash, liquid real estate debt, operating cash flow and available credit to theoretically withstand two years of maximum permitted outflows.

Nonetheless, BREIT did opt to sell a high-quality asset. It sold its 49.9% interest in MGM Grand Las Vegas and Mandalay Bay Resort on attractive terms, but the fact that the buyer, VICI Properties, was the other party in the joint venture is likely to have eased the transaction. Other sales by non-traded REITs may need to be offered with discounts.

Who are the likely buyers of these assets? The BREIT transaction offers a suggestion: VICI Properties is a public REIT specializing in casinos. This would mark a change from recent years, when some of the huge flows that went into non-traded REITs were used to acquire listed REITs and take them out of the public market.

To reiterate, this remains a potential opportunity for now. But even if continuing redemptions do not force non-traded REITs to sell real estate assets, the apparent end to their golden age of fundraising is likely to make them less powerful competitors in the market for high-quality assets. For well-capitalized, modestly leveraged public REITs armed with plentiful dry powder, we think that could result in a bigger, more attractively valued opportunity set in the months ahead.

The economic slowdown that appears to be getting underway is likely to be difficult for any risky asset class. That said, real estate can offer inflation-adjusted returns and cash flows that have made it relatively resilient in many past recessions. Publicly traded REITs, in particular, are currently available at attractive absolute and relative valuations, with an interesting emerging opportunity set. We believe that creates a meaningful buffer against downside risk.

Index Definitions

The **FTSE Nareit All Equity REITs Index** contains all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. It is part of the FTSE Nareit U.S. Real Estate Index Series, which is designed to present investors with a comprehensive family of REIT performance indexes that spans the commercial real estate space across the U.S. economy. The index series provides investors with exposure to all investment and property sectors. In addition, the more narrowly focused property sector and sub-sector indexes provide the facility to concentrate commercial real estate exposure in more selected markets.

The **NCREIF Fund Index—Open-End Diversified Core Equity Fund Index** is a capitalization-weighted, gross of fee, time-weighted return index of the performance of the net invested capital of open-end funds whose investing style typically reflects lower risk investment strategies utilizing low leverage and generally represented by equity ownership positions in stable U.S. operating properties diversified across regions and property types.

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