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Real Estate Diversification via Structured Investments

Structured investments can enable real estate investors to move into a new market while limiting risks.

By Gabriel Pozo, Advalurem Group

Gabriel Pozo

TODAY'S HIGH PROPERTY pricing is pushing real estate investors toward the outer limits of acceptable risk. According to Real Capital Analytics, the average cap rate for apartment properties nationwide was 4.9 percent in the first three quarters of 2017. As the market continues to face low property yields, pressure mounts for real estate investors to seek higher returns in alternative markets and/or asset classes where there is less competition. This is what happens, for example, when a multifamily operator moves into student housing, or when a local real estate company acquires a property in an unfamiliar market.

Moving into a new market or product type can be profitable, but it may also result in the investor taking on a disproportionate amount of risk for the expected increase in yield, especially as the real estate company drifts from its core competency into unfamiliar markets or asset classes. These inves-

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tors risk overpaying, carrying bloated expenses, missing revenue targets and, overall, underperforming relative to their peers who specialize in that location and property sector.

A relatively safer diversification strategy is to form and acquire different classes of ownership interests in real property within an investor's core market or product type. These structured investments, such as joint venture equity, preferred equity and convertible equity, among others, offer an opportunity for better overall risk-adjusted returns. For example, owning a preferred equity interest in a property may provide a built-in discount to market value and/or acquisition cost basis by having seniority over the common equity interest, providing investors with an added margin of safety. Of course, this type of investment would carry a lower return expectation compared to common equity. But a preferred equity investment can be an effective way to achieve equity returns with some degree of downside protection, especially in today's economic cycle.

For this strategy to work, however, a real estate investor must have disciplined underwriting, as well as structuring expertise. The latter is critical in arranging different classes of ownership interests, setting sequential payment terms, providing possible convertible features and establishing management control rights, among other requirements. Investors also need robust asset management capabilities to set strategy, oversee managers and work out unforeseen problems during ownership. Outside of an investor's core market, it is essential to form partnerships with local experts, with the aim of building a diversified portfolio of real estate across geographic locations and property sectors as well as types of investments.

When faced with a competitive market environment like today's, it is not enough for real estate investors to consider only in what product types and where to invest. They must also consider how to do so. Simply widening one's sectors and markets can result in unnecessary risk. Successful real estate investors who can pivot along the ownership/capital structure have a better shot at hitting the mark between risk and reward. ■

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