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REAL ESTATE INVESTING FOR THE NON-PROFESSIONAL

By, James P. Nelson, Partner, Massey Knakal Realty Services

Trophy office building sales tend to dominate the headlines. Rightfully so, as large sums of money are changing hands. These transactions usually trade from one institutional buyer to another and involve complex capital structures fueled by private equity funds and the CMBS market.

Unless an individual invests in a REIT or a real estate centric private equity fund, he or she has little or no exposure to these transactions. Even if they do, they might not be achieving the diversification that they seek, as REITs often follow the stock market. In fact from 1978 to 2011, the correlation between REITs and small stocks was .75, whereas real estate owned was .08, according to UBS.

With this in mind, the obvious question is how can an accredited investor diversify his or her portfolio to include proper exposure to real estate? Owning and maintaining property can be very time intensive and require a great deal of expertise. Thus, a good alternative is to invest with an experienced real estate operator.

There are a countless number of small to mid-sized operators around the US who syndicate their transactions. They oftentimes purchase assets with total capitalizations under $25m so they do not compete with larger institutions. These sales are plentiful; in the New York metro area 92% of the building sale transactions were under $25m in 2011.

On such operator targeting this space is Matt Blesso, Founder and CEO of Blesso Properties. Matt started his firm in 1999 and has since completed nine projects and has three more underway. He targets value-add opportunities which can yield returns well into the double digits for his investors, ranging from New York condo conversions to a hotel conversion in Panama.

Operators like Blesso must be able to raise more equity today, as lenders are providing less leverage; of about 60-65% depending on the asset class. So for a $10m purchase, which can support

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60% debt, a general partnership will need to come up with a least $4m of equity, not including the acquisition costs of which they will typically raise 75-90%. If they are lucky, they may have one or two high-net worth individuals who can cover the entire amount if needed.

However, most of the time small accredited investors (with net worths above $1m or earnings of $200,000 in each of the last two years) will typically invest amounts of $50k -$250k, meaning a $10m transaction may have up to 30 limited partners. Coordinating all these investors in a short time before closing can be exhausting and challenging for GPs especially in New York where sellers look for 10% non-refundable contract deposits and no contingencies in a sale.

One sponsor who has been very successful raising equity in a short time frame is Benchmark Real Estate Group LLC in New York. The principals, Jordan Vogel and Aaron Feldman, started their company just over three years ago and have already closed on 15 transactions.

Benchmark has 90 investors who have contributed about $70m during this time. This is no small feat as passive investors can be tough to find. Non-real estate professionals can often balk at a speculative real estate investment. An LP has to be sophisticated and knowledgeable enough in real estate to understand opportunity and be willing to handle the downside of losing the entire investment.

“Most of our investors are high-net worth individuals or family offices who are not in the industry and seek exposure to Manhattan real estate. We provide an investment platform which allows individual investors to diversify their equity among various properties while achieving an exceptional risk adjusted return,” Vogel said.

Depending on the asset class, risk profile, GP experience and track record, and current cash flow (if any), LPs can look for initial returns of 6-25% plus a potential share of the residual profits. The LPs will typically receive their equity back first, followed by the GP. Once the LP receives their preferential return, the GP’s will receive their return. After the preferential returns have been paid, the GP will usually take a larger share of the residual profits anywhere from 20-50%. A GP who demands a high pref from his LPs might offer a much higher split on the back end.

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