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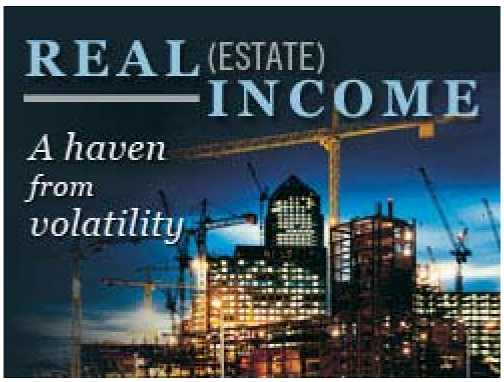
THE PROS OF PRIVATE REAL ESTATE

Doug Watt / May 23, 2012



Private real estate can be suitable for clients looking to offset the volatility of stock markets. But as an asset class, it's not without risk, and it is governed by a complex set of rules.

Public real estate investment trusts (REITs) are well known to most investors. Private REITs offer the same trust structure, but don't trade publicly. It's a format favoured by Greg Romundt, president of Centurion Apartment REIT, a private investment structure focused on apartment buildings.

Private REITs are a fairly limited market, Romundt says.

"Getting to a scale where it makes sense to organize as a REIT, you need a certain amount of infrastructure. At a small scale, it can be very hard to make the numbers work for investors or operators," he says. "And if you're going to get to a certain scale, there's temptation to take the company public. One of the reasons we've stayed private is we are addressing a core need for an underserved market segment."

Romundt notes private REITs are limited to accredited or eligible investors. "The requirements are provincial, based on residence," he says. "If you live in Ontario, you have to be an accredited investor or invest a minimum of $150,000. Outside of Ontario, the rules are different because they have exemptions for eligible investors."

No public trading means a lack of liquidity for private REITs. Centurion offers redemptions on a monthly basis, subject to certain limits. Still, Romundt points out private REITs are intended to be long-term investments.

"For most people, you should be looking at a holding period of five years and up," he says.

The bulk of Centurion's investors come to the company through their investment dealer and fall into two categories: retirees and pre-retirees. "Retirees are looking for cash flow stability, some inflation protection and capital preservation," Romundt says. "All of those things are consistent with the performance of real estate over a long period of time."

Income may be less critical for pre-retirees, he says, but tax efficiency is important, as is building capital.

“I would say real estate should be in everyone’s portfolio, in addition to stocks and bonds, so it’s all part of a diversified strategy,” he says. “I wouldn’t tell anyone to be all in real estate; you want to have a diversified, well-thought-out plan.”

REITs aren’t the only private real estate investment. John Nicola of Nicola Wealth Management in Vancouver offers access to a private real estate limited partnership (RELP). A RELP is similar to a REIT, Nicola notes, in that it has flow-through taxation. “So whatever occurs at the LP level is passed on directly to the partners.”

The RELP market is larger than the private REIT market and there are no accredited-investor limitations. “We’re able to recommend these to any of our clients, but generally it is a sophisticated investor asset,” he explains.

And the structure isn’t without risk. “There have been recent examples of real-estate partnerships that went into receivership, so from that perspective, it can be risky. If a RELP follows a certain set of guidelines, the risk is really quite low.”

Nicola tries to mitigate risk with “rigid and specific” guidelines for buying assets. First, he and his partners invest alongside clients, “so anything that is going to cause potential loss is going to affect us exactly as it would affect them.” Secondly, the firm typically doesn’t buy any building without committing to a down payment of between 30% and 50%. “So we get better pricing on the mortgage.”

The firm also looks for a net income stream that’s at least two percentage points higher than the mortgage rate.

Nicola says partnerships that have run into trouble have been either highly levered or invested in things that don’t produce income or aren’t focused on future development. Nicola prefers a more conservative approach.

“You have to work with someone that you can trust, who knows the terms and conditions of the real-estate partnership,” he says. “If you can’t see that, then your choices are to buy into a real-estate trust, a mutual fund that invests in real estate or a real-estate segregated pool.”

Nicola says advisors and investors have to do due diligence on structures like RELPs. “With [public] REITs and mutual funds, you’re just buying the asset class and deferring the decisions to a manager,” he says. “If you’re going to get into actual direct real estate ownership, which is my personal preference, you’ve go to do some homework.”

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