Wealthy U.S. Individuals Invest in Commercial Property in Quest for Yield

When Sumeet Parekh bought a retail property in Manhattan's TriBeCa neighborhood in January, individual investors provided about a quarter of the financing.

Morgan Stanley (MS) put up a little more than half of the $6 million purchase price, and Parekh contributed about $1.25 million. He got the rest from wealthy investors, who contributed increments of $100,000 to $625,000 in hopes of a 10 percent annual return and a portion of the building's appreciation, said Parekh, a principal at San Diego-based HP Investors, which owns and invests in commercial properties.

High-net-worth individuals invested $2.1 billion in commercial real estate last year, up from $579 million in 2009, according to Real Capital Analytics Inc., a New York-based research firm. Apartments were the properties most sought after by investors last year, accounting for 32 percent of deals they were involved in, according to Real Capital, which has tracked more than $5 trillion in global sales transactions since 2001.

"Commercial property looks damn attractive versus other asset classes right now," said Dan Fasulo, managing director at Real Capital. "Everyone's looking for some form of inflation protection. They're buying gold, they're buying oil, or you can buy property. It has inflation protection characteristics, plus it gives you a check every month."

Prices for commercial property have dropped 42 percent since their peak in October 2007 through December, according to the Moody's/REAL Commercial Property Price Index. The index posted gains in three of the last four months of 2010 as individual and institutional investors including the Hartford Financial Services Group Inc. bet on a rebound.

Apartment Demand

Demand for apartment buildings has risen as the foreclosure crisis forces more people to rent and the children of baby- boomers move from college dorm rooms to their first residences. Rents climbed 4.3 percent in the last three months of 2010, the most since the third quarter of 2006, according to Dallas research firm Axiometrics Inc., while U.S. homeownership rates in December remained at a 10-year low, according to data compiled by Bloomberg. Axiometrics projects a 6 percent increase in U.S. rental revenue by the end of 2011 from December 2010.

"There's a lot more equity that wants to get in the real estate market, particularly from high-net-worth individuals," who want the higher returns without the onus of managing a property, said Robert Knakal, chairman of the New York-based commercial property brokerage Massey Knakal Realty Services. "They don't want to get a call at four in the morning that something is broken, or there's a fire or the toilet is stuffed up," Knakal said.

Low CD Yield

Low yields on other investments are driving investors to real estate, said Knakal. "Look at what your options are: Are you going to buy a CD and get 50 basis points on your money? Or buy a 10-year Treasury and get 3.46 percent?" he said.

The average capitalization rate on commercial properties excluding hotels was 7.2 percent as of the fourth quarter last year, Real Capital data show. Cap rates are a property's net income divided by the purchase price.

Investment-grade U.S. corporate bond yields were 4.01 percent as of March 7, according to the Bank of America Merrill Lynch index. Rates for 10-year certificates of deposit averaged 1.48 percent as of March 7, according to Market Rates Insight, based in San Anselmo, California.

Clients from athletes to entrepreneurs have moved 3 percent to 5 percent of their cash into real estate deals in the last year as a way of adding assets that may protect portfolios from inflation

and stock market volatility, said Rick Flynn, head of the family office group for Rothstein Kass, an accounting and advisory firm in Roseland, New Jersey, serving those with a net worth of at least $10 million.

Not Complicated

“Families are really excited because everything else they’ve been sold in the last five years had a lot of complicated structures that they never really understood, whether it’s a hedge fund or a structured product,” said Toby Moskovits, chief executive officer of Heritage Equity Partners in New York, whose firm has advised families who invested $30 million in apartment deals in the past six months.

The building Parekh bought has a major tenant, Petco Animal Supplies Inc., he said. Investors have an equity stake in a partnership that owns the property and get a share of its cash flow and future appreciation based on how much they contributed, said Parekh. His firm told investors they would receive at least a 10 percent return on their investment annually after it collected the monthly rent and paid bank debt.

Holding Period

Individuals are tying up their money for an estimated holding period of 10 years to 15 years, according to the operating agreement, Parekh said. The property may be sold earlier, he said. Parekh takes a fee of less than $350 a month for managing the property and a portion of the property’s cash flow after investors are repaid, he said. Parekh, 34, used to acquire and manage real estate investments in New York for Washington-based Carlyle Group, the world’s second-biggest private-equity firm, he said.

Investors who concentrate their money in one or several properties may take on more risk, while investing in a real estate investment trust, or a REIT, provides more diversity across the market and greater liquidity, said Craig Leupold, president of real estate research firm Green Street Advisors Inc. in Newport Beach, California. The Bloomberg REIT Index of 124 publicly traded property owners, including apartments, office buildings and shopping centers, climbed 23 percent in the past year.

“You have to be very careful of being lured by yield,” said Lew Altfest, president of New York-based Altfest Personal Wealth Management, whose clients have a minimum of $1 million in investable assets. If a property owner defaults, a family could end up managing a property, be involved in litigation and incur legal costs before a property can be repossessed and put up for sale, Altfest said.

Illiquid Asset

“Anytime someone purchases real estate they have to understand they are buying an illiquid asset,” said Jeff Sica, president of Sica Wealth Management in Morristown, New Jersey. Sica said he helped in real estate deals with a combined value of $200 million for four families in the last year with an average holding period of 10 years. He seeks apartment buildings with a cap rate of 6 percent to 9 percent annually.

Families should compare what they may be charged in “promotes,” which are similar to carried interest fees paid to private equity and hedge funds, to other investments, said Wayne Heicklen, an attorney and chairman of the real estate department at the law firm Pryor Cashman LLP. Heicklen said he has worked on deals including Parekh’s purchase in TriBeCa.

Investors should also investigate the sponsor and inspect the property, said Heicklen. “They were offering great yields yet the tenant wasn’t there for the full time and the location was bad,” he said of one property his clients were evaluating.

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