Real Estate Private Equity 101

- **Purpose:** Just like with normal PE firms and LBOs… use debt and equity to acquire a property, grow it over time, and then sell it

- That same **housing analogy** applies… but here, it really is a house we're buying!

- **But**… the modeling itself might be much *simpler*, or possibly more *complex*

This Tutorial

- **Part 1:** The Types of RE PE Case Studies

- **Part 2:** This Case Study and What Makes It Tricky

- **Part 3:** How to Challenge the #s with Scenarios

- **Part 4:** The Property Model

- **Part 5:** The Investment Recommendation

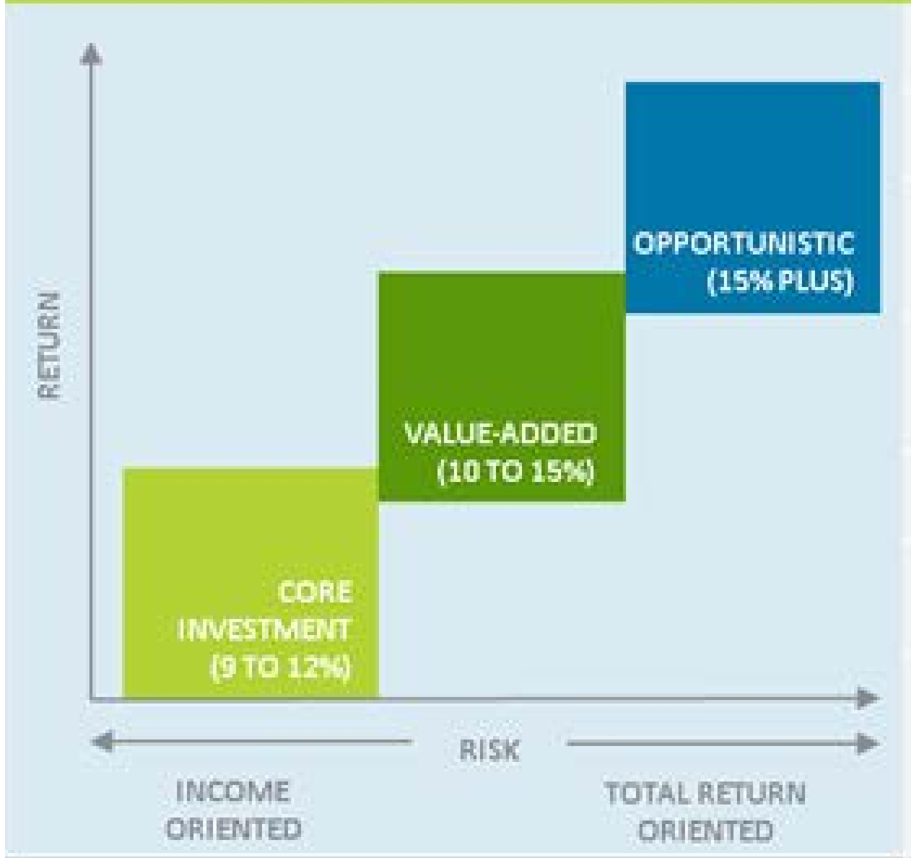
Three Types of RE PE Cases

- **Core and Core Plus:** Nearly the same, in practice

Three Types of RE PE Cases

- **Key Question:** How much is the property *changing*?

Figure 1: Risk/Return Styles



	CORE	VALUE-ADDED	OPPORTUNISTIC
RISK:	Low	Medium	High
TARGET RETURN (IRR – PRE TAX NET OF FEES):	9-12%	10-15%	15%+
SOURCES OF EARNINGS:	Current income (70%) + capital appreciation (30%)	Current income (50%) + realised capital appreciation (50%)	Current income (<20%) + realised capital appreciation (>80%)
HOLDING PERIOD:	5+ years	3-7 years	2-5 years
FINANCIAL LEVERAGE:	0-50%	30-70%	50-80%
BUILDING TYPE:	Quality assets with long leases and quality tenants, fully or almost fully occupied	Assets with upside potential through refurbishment, re-leasing and repositioning	Development assets, distressed assets

Modeling Complexity

- **Key Questions:** How <u>granular</u> is it (individual tenants and leases), and how much is the property <u>changing</u>?

- **Easiest:** Stabilized property with hundreds of tenants, not changing at all over time

- **Most Difficult:** Office or retail complex with 10 tenants with different lease terms, changing significantly over time

This Case Study

- **Property:** Stabilized Multifamily in Seattle

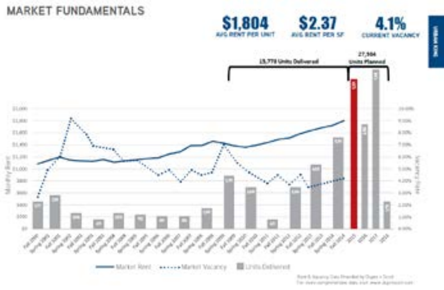
- **Question:** Should we pay $120 million to acquire it, if we’re targeting a 10-year 10% IRR?
- **Other Terms:** 70% LTV (Loan-to-Value, the % debt used), 3% baseline income and expense growth, various figures for CapEx, TIs, and LCs

What's Tricky About This Case…

- **Trick:** Give you <u>lots</u> of detailed information on the unit mix… many people would start with that!

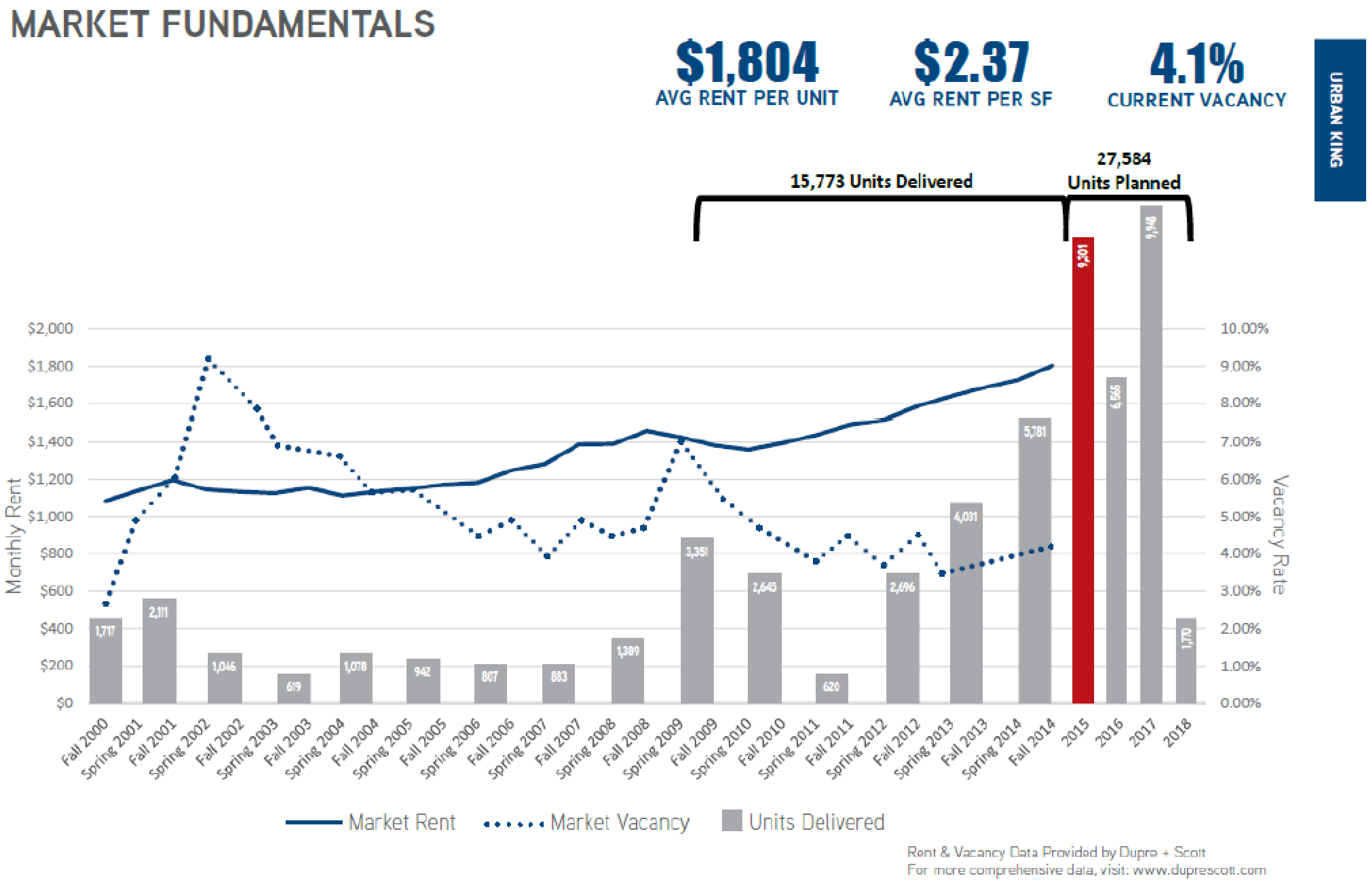
- **But:** Doesn't make a huge difference; better to simplify and focus on "average rent per SF" and think more about the market

- **So:** Spend the time reviewing the rent, vacancy rate, and cap rate data, and use that to build operating scenarios



Scenarios

- Do you **really** think rent and expenses will just grow at 3% per year, given the graph below?



Scenarios

- **Scenario #1:** Base Case – Use their figures and assume no real market cycles

- **Scenario #2:** Immediate Market Decline, Recovery, and Stabilization – Rent and expenses decline and TIs/LCs rise, and then those trends reverse

- **Scenario #3:** High Growth, Decline, Recovery, and Stabilization – Rents continue to grow for a few years, then decline, recovery, and stabilize

Why Scenarios Matter

- **Real Estate:** All the assumptions are interrelated!

- **Example:** If rents fall by 10%, the vacancy rate will almost certainly rise, and landlords will also have to pay more to attract tenants – soft market!

- **So:** You can't just look at rental growth or declines in isolation since other assumptions change

The Property Model

- **Pro Forma:** Total Potential Rental Income, Vacancies and Other, OpEx/Maintenance CapEx, Capital Costs

- **Debt:** Simple IPMT and PPMT functions here

- **IRR and NPV:** Unleveraged and leveraged basis

- **Conclusions:** No way we’re getting a 10% IRR on this deal

The Investment Recommendation

- **Point #1:** The numbers don’t work, even in more optimistic outcomes
- **Point #2:** We may run into issues with the DSCR
- **Point #3:** Asking price is too high; $100 million is better
- **Point #4:** We’d need faster rent growth with no declines, a lower asking price, a renovation, or a different entry point to make this work

Recap of This Tutorial

- **Part 1:** The Types of RE PE Case Studies

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- **Part 5:** The Investment Recommendation