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The Right Fit - By Michael Dowd - 08/4/2008

Planners and wealth managers considering adding private equity to their accredited high-net-worth clients' portfolios may achieve higher total returns by making a private equity allocation in certain business sectors that are benefiting from demographic shifts and changes in the economy. Expectations, however, should not be pegged to some of the dramatic performance returns seen elsewhere, such as those publicly reported by the Washington State Investment Board.

Even in this recently tempestuous market, several major leading-edge pension fund managers such as the Washington board, which has $68 billion, have been allocating a larger portion of their funds' assets to private equities. Washington state recently boosted its private equity target allocation from 17% of assets to 25%. The Oregon Public Employees and the Pennsylvania State Employees Retirement Systems are the next most aggressive at 14%.

The dodgy stock and bond markets, which until quite recently were close to trading at all-time low yields, are typically the reasons offered when planners and wealth managers begin to consider exchanging some of the liquidity of public securities for what they hope will be the higher yields of private equity placements.

Any private investment the portfolio manager might consider will necessarily involve the cost of a reduction of liquidity. As a result, the analyst will need to believe he's getting something in yield or total return that he has reasonable confidence will outperform the opportunities available in the public sector. Financial analysis is ultimately based on supply and demand, and the analyst needs to focus on demand drivers he can understand and believe in, and to find sponsors and managers who know how to deliver results in the real world. Considering this, there are specific investment areas he might want to consider.

Upper-End Extended-Stay Hotels

Well-selected, upper-end extended stay hotels offer interesting opportunities for patient, yield-driven investors. Here, private market yields of 8% to 10% can be found, featuring growing but well-regarded brands such as Hilton's Homewood Suites and Marriott's Residence Inns. Business travelers who may be in town for a few days like the larger rooms and high-tech amenities these brands offer. They like the free breakfasts they can get easily in the morning. After that, they typically prefer making their own meals or dining out in local restaurants rather than the usual food available in most full-service chain hotels.

Once the residence hotels have been developed and rented, there has been a ready market for a takeout or purchase by the better hotel REITs. Direct investment in those same REITs, though, have been hurt by increased volatility—and from yields that are 300 basis points lower than what the private placement market has been providing, if not more. When considering a private placement in this sector, look for newer or better quality to-be-developed properties. There are older hotels in the world—The Plaza in New York or The Ritz in Paris—that look wonderful after one hundred years, but few properties built in the last 30 had that kind of design or craftsmanship. By the time even a good quality franchise property is 30 years old in the U.S., it typically has been renovated two or three times already and there's not much one can do to upgrade it enough that it would compete for business travelers with larger rooms, free Wi-Fi, full services for electronics and a free breakfast buffet. The old services a good business hotel used to offer (a restaurant, a shoeshine, a barbershop, etc.) are only provided today in four- or five-star hotels, and not in all of them. Convenient parking near an interstate highway or an airport will attract more business travel today, but a new Hilton Homewood Suites with free parking and larger rooms can often smoke the performance of a 25-year-old "full-service" suburban Hilton.

The private market investor would like to believe that when his property is fully complete and marketed it will sell to a hotel REIT at a cap rate in the 7%-8% range. Even if the analyst has faith in the demand, investors should take care. It is critical to look for experienced operators, transactions where there is some real shared motivations between the sponsor, the manager and the investor, and where the properties are themselves not

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overleveraged.

Private Student Housing
The bright spot of private student housing is worth a look by planners and wealth managers who will consider an alternative niche play to keep their clients fully invested in the real estate portion of their portfolio. Well-managed private student residences built by companies with strong records and expertise could increase an investor's yield, reduce the volatility of his real estate portfolio, and even, perhaps, increase the typical internal rate of return of a real estate play.

There are reasons for this optimism. In the last five to ten years, the housing product that attracts students has evolved. Far more of the student housing put on line has been single-student bedrooms, in suites and apartments, most with private bathrooms and many with fully equipped kitchens.

Cash-strapped universities have focused their own resources on improving faculty and classrooms, but increasingly turned to private real estate developers for a number of benefits: off-balance-sheet and off-credit financing with no contributions or guarantees from the school; turnkey development services that relieve the universities' typically overburdened administrative staff; expedited development and delivery schedules; more innovative and market-driven designs and amenities; and lower costs that provide reasonable rental rates for self-supporting projects.

These privately financed properties contrast with most existing university-operated housing that is 30 years old or older. Much old housing stock has small, double-occupancy bedrooms, limited storage space for the modern student's computers and paraphernalia, barracks-like bathrooms, little or no privacy, and significant challenges for setting up and using electronic equipment such as computers, music systems and electronic games.

Students are demanding more, and their parents are obliging them.

This preference for single-bedroom housing will soon collide with demand prompted by the demographics of baby boomers' children, specifically the "echo boomer" cadre now just hitting college age. College enrollment is expected to increase over the next 20 years; between 2002 and 2012, enrollments are expected to increase by 13.2%. More high school graduates are going to college. Most plan to attend full time and typically will take five years to finish, not four. Full-time student populations are expected to increase even faster (16%) and those are the most likely students to require housing on or near campus. By 2012, 60% of college students will be women, and the design of dormitories must respect this increase. Parents of all college students will want their children to be within walking distance of campus, will value good security and want management that values relationships with its students.

The proliferation of private student housing has provided a substantial database, allowing industry experts to establish informed guidelines for development, construction and operating costs, as well as appropriate reserves for capital replacement, financing and operations. Again, it is essential that the managers and sponsors of the private transactions know what they are doing.

Bundled Credits
In a debt world where high yields from good quality credits have been hard to come by, several firms are bundling credits from unusual, good quality sources. While the quality of the underlying credits may be high, and sometimes even rated, the securities themselves will not have been publicly registered or individually rated by the agencies, usually because the packages are too small and the costs would be prohibitive.

Ten-year fixed yields should be several hundred basis points above the benchmark Treasury, and they should only be considered if the spread is sufficient for the loss of liquidity. Such credits have recently included the bundling of service contracts such as residential burglar-alarm services, oil-production leases and various forms of debt from private real estate owners and operators.

Apartment Sectors
In the direct real estate area, there are at least two apartment property sectors where the strength of future demand growth is demonstrable, and many of these properties are in geographic areas or markets that the analyst may conclude are underserved. These are areas where the investment opportunities are not yet available in sufficient volume to create targeted publicly traded investment vehicles. Specifically, the investments are in private, market-rate senior housing sector and aforementioned student housing sector, which are both insulated from the single-family home market and the collapse of the mortgage markets. In many geographic areas, these investors may presently be underserved. In the current market, private investments can be found at yields of 7% to 9%, which is about double the current yield on apartment REITs.

The basic senior rental housing demand driver is clear. Between the end of World War II in 1945 and the slowdown in births in about 1964, 76 million Americans were born. They are turning 60 today, about every eight seconds, meaning this group will inevitably be the fastest-growing segment of U.S. demand for 18 years, through 2024, when the last one hits 60. Analysts who study that market will tell you that only about 10% of those seniors who are qualified for independent senior rental housing by age and income will move into such properties, but in many geographic markets there is only enough existing housing to accommodate 3% to 5% of the qualified candidates. Projected five-to-seven-year IRRs in

the high teens seem realistic to some observers.

Student housing demand is more "university-specific"—meaning it depends on whether a specific college or university has been growing and whether it is likely to continue doing so. It also depends on what percentage of its students are full time (and thus much more likely to need local housing), and what percentage are commuting. You must also ask how many of its students are currently housed in university-owned dorms and what rates are they paying. Parents will generally pay a pretty good premium over what the institution charges to get their children out of off-campus housing and into a safer (non-"Animal House") environment, but probably not pay 30% more. While the private equity analyst may not need to determine each of these factors himself, it is critical to be certain that the sponsors and managers know these university-specific variables. They must also have policies and procedures to show that they can deal with students, attract good tenants and avoid "Animal House" atmospheres that scare parents.

Oil And Gas Trusts
There are also oil and gas trusts, whose assets are based on existing, proven, producing wells. Many investors believe these trusts, structured as alternative investments, provide both attractive yields and a reasonable chance of appreciation, depending on the price of oil and the price of the security at the time of the investment. Investors who bought good ones two or three years ago are doing very well indeed. Whether there are more "legs" in oil prices as they approach $150 per barrel is something that each analyst needs to consider for himself.

Accounting Issues
Typically, though not always, all such private company offerings are structured as LLCs and LPs. The usual cautions apply. Specifically, "publicly traded" partnerships will be taxed as corporations, which can seriously reduce after-tax IRRs. You should decide whether competent accountants and attorneys are involved. Assuming the deal passes this hurdle, the following issues should be considered.

• If the investor is a tax-exempt entity, unrelated business taxable income (UBTI) issues need to be considered. In the case of a real estate investment, the LLC or LP will often take on real estate mortgage debt. Under the tax code, typically first-mortgage real estate mortgage leverage will not trigger UBTI. Nonetheless, find out whether the entity will receive any "service income." This might be the LLC operating a restaurant or providing personal services to tenants. Typically, if the service revenues are a small portion of total revenues, they will not trigger UBTI. Overhead and other costs will usually offset revenues and eliminate any profit. So there should be some language in the offering documentation that the manager will use commercially reasonable efforts to ensure that will not happen. Should the property generate UBTI for some reason, and should the investor be a tax-exempt entity, the member would be required to file a tax return and could incur a tax liability.

• Investors among charitable remainder trusts (including charitable remainder annuity trusts and charitable remainder unitrusts), however, run a much greater risk. They are not exempt from taxation in any year in which they realize UBTI. In these cases, a trust's investment in an entity could trigger tax on all the trust's income in that year (including income from other sources). Given the potential for such disastrous results, these investments are generally not appropriate for charitable remainder trusts.

• For certain taxable investors, there can be other benefits. Over the first ten years or so of a real estate transaction, the cash distributions will often be sheltered from tax by depreciation, and there may be excess passive losses that investors with passive income can use to offset that income.

Those financial advisors and wealth managers interested in doing the analysis may find that such private equity investments can give them opportunities to differentiate themselves, improve their performance and keep the loyalty of high-net-worth investors who are looking for ideas and execution that are more interesting and promising than investments available to those who are less wealthy.

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