

REAL ESTATE INVESTING:
**WHERE & WHAT IS THE
RIGHT FIT FOR YOU?**



In our globalized society, investing in international real estate has become more accessible than ever. However, the vast selection of available real estate investments can be overwhelming. Investors can miss out on opportunities that could be perfect for them when they are overloaded with choices. LCR Wealth, as a Registered Investment Advisor (RIA), has extensive research on, and a deep understanding of, a plethora of real estate investments offered in the US capital markets. To help investors understand the selection available, LCR Wealth has broken down the differences among several strategies and structures of real estate investment.

Real estate investments can be broken down into **three** broad strategies:

- ① Sector-based strategies
- ② Geography-based strategies
- ③ Net lease investments

What Is a Sector-Based Strategy?

Sector-based investments focus on one sector of real estate. These sectors include residential, commercial, industrial, office, warehouse, healthcare, and retail real estate, among many others. Sector-based investments aim to gain direct exposure to a portion of the real estate market that meets certain criteria. This specificity allows investors to make targeted investments based on the sector of real estate that they believe will perform well.



An example of an event that could motivate an investor toward speculative sector-based investments was the COVID-19 pandemic, which forced many businesses to require their workers to operate remotely. As the United States and other countries have emerged from the pandemic, many workers have continued to work remotely. This trend toward remote work incentivized many investors to sell their investments in office real estate, causing price drops in that sector. And, because remote work still continues post-pandemic, prices in the office sector have not seen the recovery experienced by other parts of the real estate market since mid-2020.

The industrial sector was also affected by COVID-19—but with a difference. At the onset of the pandemic, many industrial facilities were closed, with no estimate of when they would reopen. As in the office sector, this uncertainty led to selling activity and price declines. Unlike the office market, however, the industrial sector has since then made a sharp recovery, because industrial production rose significantly throughout 2021 and 2022. If an investor believes that the industrial sector will continue to outperform other real estate sectors, then that investor might consider investments specifically in the industrial sector.

What Is a Geographic-Based Strategy?

Geography-based investments focus on real estate in certain locations. This specificity serves a similar purpose as sector-specific investments, but using geographic location as the criterion for investment. Large businesses have traditionally centered themselves in well-known business hubs such as San Francisco and New York. But these same companies have relocated offices and workers to areas with more favorable income tax treatment, such as Austin and Miami. Investors watching similar trends can seek out geography-based investments in up-and-coming areas.



What Are Net Lease Investments?

Net lease investments refer to the type of rent agreement between tenant and landlord. In a traditional lease, the tenant pays the agreed-upon rent and usually variable utilities costs for water, heat, and electric. In a net lease agreement, however, the tenant takes on the liability of paying some, or all, of the other ongoing expenses related to the property: **insurance, taxes, and maintenance**. If the tenant pays for all three of these expenses, then the lease is categorized as a “triple net lease,” which is often shortened in the real estate industry to “NNN.” Since the tenant is agreeing to pay for these expenses, the base rent for the property is reduced relative to a traditional lease.

Why would someone seek out a net lease agreement? Net leases are usually agreements between long-term (5+ years) **tenant businesses** and landlords. By handing off the variable ongoing expenses to the tenant, the landlord simplifies the profitability of the investment. The landlord only needs to consider how much rental income they take in against the cost of any mortgage liabilities on the same property. Without a net lease agreement, it is less likely that the landlord would accept a 5+ year agreement, since the variable expenses could rise unexpectedly. On the other side of the equation, the tenant business wants to ensure that it will have the location for a longer period, without having to go through repeated negotiations. By agreeing to a net lease, the business secures a fixed base rent for a long-term lease.



As with sector specific and geographic-based investments, when investing in net lease strategies you are supplying the landlord with capital in exchange for a piece of any future cash flows. Net lease strategies tend to be more conservative and reliable, but with less growth potential. This is primarily due to the fixed rent & cost structure discussed above, but there is another essential factor. Net lease investment managers tend to seek out “recession resistant” businesses as tenants. These tenants include dollar stores, gas stations, and fast food or fast casual restaurants, to name a few. Since these businesses tend to maintain performance in all economic cycles, the idea is they will be better suited to make rent payments for the full term of the lease even if the economy goes through a downturn.



Which Real Estate Investment to Choose?

The potential combinations of **sector, geographic, net lease**, and other strategies are endless. To find what fits best in your portfolio, it helps to first evaluate your own personal investment goals and experience.

Investors with limited experience in real estate investing, or those who don't have substantial capital, should heavily evaluate their needs and goals before making a high-risk speculative

investment. For these investors, it is likely better to find an investment that avoids overexposure to any one sector or location, also known as a diversified real estate strategy. Diversified real estate has recovered from the initial pandemic selloff and has since appreciated throughout 2021 and 2022. Once an investor understands which strategy they would like to seek out, and ensures that it fits their risk profile, they can begin asking about the structure of the investment.



Common Real Estate Investment Structures

- 1 Direct investments
- 2 Private Funds
- 3 Real Estate Investment Trusts (REITs)



What Is Direct Investment?

Direct investment is the most traditionally well-known form of real estate investing, in which a person or group invests in real estate by purchasing an individual property, renting it out, and acting as landlord. This method of real estate investing has been a source of passive income for untold many investors over thousands of years. As a result, many investors have an affinity for this method over modern financial products. This comfort with direct real estate is understandable, since many people learn the art of direct real estate investing from parents or other relatives. Direct real estate is a core foundation of a real estate investor's portfolio, but, according to Forbes, "direct real estate investing, for all its upside, has many downsides." When exploring the pros and cons of different real estate investment structures, it is useful to consider **control, risks** and **average returns, diversification, liquidity**, and **involvement**.



Control is a defining characteristic of direct real estate investing. The investor is usually the outright owner. They have full discretionary authority over all aspects of the property. If the investor purchased the property with a group, then each member of the group, within the bounds of any internal agreements among the members of the group, has full discretionary authority over the property. In most if not all other real estate investment structures, the investor gives up control to a professional investment manager.

Each individual property has its own set of **risks and return** characteristics; but on average, direct real estate has a return between **6%** and **8%** annualized. Investing in areas with strong real estate price growth, or adding value to a property through renovations, can increase returns above the 6% to 8% average. On the other hand, significant losses can occur because of a struggling local economy, a specific property issue like mold, vacancy, or new regulations/taxes, and other risks.

Diversification is the process of lowering risks and improving returns by spreading capital across various uncorrelated investments. If one investment does well and another does poorly, they can offset each other. People often use the idiom “don’t put all your eggs in one basket” to explain the benefits of diversifying their investments. If the basket drops and you are not diversified, all your eggs are going to break—but if you keep your eggs in different baskets, only some will break. It is difficult to take advantage of the benefits of diversification through direct real estate. Investors need substantial capital to purchase enough individual properties to create a diversified real estate portfolio. This means that direct real estate carries a large amount of property-specific risk. If there is an issue with one property that causes a loss, it is unlikely that an investor will have enough profitable properties to fully offset those losses.



Liquidity is the ease with which an investment can be sold at or near its current market value. Individual properties are not sold easily or quickly; these investments are highly illiquid. To sell a property quickly, the owner usually needs to do something to incentivize potential buyers. The main way to motivate buyers is by lowering the price, essentially devaluing the investment to solve the liquidity issue.



Direct real estate requires the most **involvement** from the investor in terms of time and effort. In direct real estate, the investor is responsible for finding an undervalued investment and managing the property after purchasing it. Property management can be outsourced, but it still costs the investor time, effort, and money. As a real estate portfolio grows, this ongoing property management can begin to become a burden on the investor. Many real estate investors reach a point where they start placing less importance on control. Instead, they seek out investments with other benefits, such as liquidity, diversification, and

professional investment management. This is not to say that the investor liquidates properties that they already own and operate. They simply reach a point where the benefits of diversification, liquidity, and time become more important than 100% ownership and control over the property. It’s at this point that people tend to start considering private funds, if they haven’t already.

What Are Private Funds?

High-net-worth investors seeking real estate opportunities that demand less time and effort tend to lean toward private funds. Private funds are companies formed for the specific purpose of pooling capital to be invested by the fund manager. Typically, the managers of private funds are experienced and successful real estate investors who have a defined strategy and expertise.

The fund manager has sole discretionary authority to make investments using the fund's capital. Investors have no operational responsibilities to the investment fund aside from supplying capital. These terms are typically laid out in the fund's offering document, often referred to as a "private placement memorandum" or "PPM." Fund investors tend to focus their research on the manager and strategy, allowing the manager to take on the responsibility of finding and making good investments. This one-time due diligence on the fund and its managers requires much less time and effort compared to the ongoing responsibilities associated with direct real estate.

Private funds tend to have a term of 5+ years and are considered illiquid. This means it would be incredibly difficult to resell, give away, or otherwise transfer your investment to someone else. Private funds therefore have the same limitation as direct real estate, in that the asset could not be liquidated to help the investor with short-term cash flow needs.

Private real estate funds have averaged a higher return than direct real estate, for a variety of reasons. The expertise and experience of the fund managers generally leads to better investments compared to average real estate investors. By pooling capital from many investors, funds are also able to benefit from diversification. They have maintained an average return of **14.2%** as of 2020; but, as with direct real estate, the performance of each fund is independent. In most private real estate funds, the return is a combination of rental income (distributed quarterly) and price appreciation.



What Are Real Estate Investment Trusts (REITs)?

The most accessible form of real estate investing is publicly traded **Real Estate Investment Trusts (REITs)**. These are securities that trade on national exchanges like a stock or ETF (an exchange-traded fund). It is similar to private funds, in that investors come together to give their capital to a professional manager, but unlike private funds they are **liquid assets**. Since REITs trade on the open market, investments in REITs can be liquidated for market value on any day when the market is open. This is a major advantage for investors who have strict or volatile cash flow needs or who otherwise foresee needing to liquidate investments quickly.





To maintain status as a REIT, the company (trust) must invest at least 75% of its assets in real estate or real estate assets (for example, mortgage-backed securities) and distribute at least 90% of its annual net cash flow. The distributions are usually given in the form of quarterly dividends, but there are also REITs with monthly distributions.

Accessible **diversification** is a major advantage of REITs. Due to the large size of many publicly traded REITs, their investment portfolios can include hundreds, or thousands, of properties in different sectors and locations. Some REITs offer sector-based or geography-based strategies, but unlike direct real estate or private funds, they can maximize the diversification benefits within the limits of their targeted strategy. For instance, if a REIT specializes in the residential sector, it may have many different types of residential properties, including single family properties, multifamily properties, apartment buildings, etc., in many different geographic locations.

As with private funds, the average performance of the real estate experts managing REITs is higher than that of the average real estate investor. REITs had an average **return of 12%** annualized from 1977 to 2010.

One of the main downsides of REITs, as with private funds, is the investor's lack of direct control over the investments. As discussed, some investors put a high premium on the ability to have full ownership and control of the investment properties. In a REIT, all investment decisions are made by the REIT manager. The question investors must ask themselves is, "Do I value full ownership/control enough for it to outweigh potential risks?"

An often-overlooked characteristic of REITs is the daily volatility that comes with being a publicly traded liquid asset. REIT investors can see the exact market price of their investment every minute that the market is open. This characteristic can lead less experienced investors to make common blunders, such as selling out of fear after a short-term price decline. This is an example of the trade-off between liquid and illiquid investments. Liquid investments give you the option to sell at or near market value essentially anytime, but you are subject to the day-to-day fluctuations of the market. Illiquid investments restrict your ability to sell, but they aren't subject to the whims of anxious investors swayed by short-term changes in market prices.



Conclusion

There isn't one "best" real estate investment. The right solution for each investor requires balancing the trade-offs associated with the various options. For high-net-worth investors, this often means combining different strategies and structures to attempt to gain access to the different benefits. For example, a successful direct real estate investor may seek out a private fund or REITs as a way to expand and diversify their real estate portfolio without increasing the burden of ongoing management. Or a private fund investor might look to direct real estate for an opportunity to control the investment process from start to finish. And a REIT investor might seek out a private fund to shield a portion of their portfolio from the day-to-day fluctuations of the public markets.

Considering the factors of diversification, liquidity, control, and involvement with each strategy and structure, investors can build a real estate portfolio that truly suits their goals for risk, return, and cash flow. Building a portfolio will allow the investor to have a wider view of an individual investment and how it fits into their overall investment portfolio. Investors should take time to think through their current real estate investments as well as the opportunities available to them, using the tools provided in this paper, and/or with a financial advisor. By doing so, they can ensure that they are positioned as effectively as possible to achieve their investment goals.



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