Valuations: Interval Funds Vs REITs

BLUEROCK VANTAGE POINT

We often receive the question of the diverging performance across the universe of private real estate funds available to individual investors—why are some (funds) down more significantly than others? Although we have commented on the impacts of interest rates to cap rates and real estate valuations before, here we discuss an overlooked feature: the impact of real estate structure. Generally speaking, interval funds do not hold real estate directly but hold shares in private REITs sometimes geared towards large institutional investors. Given this structure, and also the '40 Act requirements on striking a Net Asset Value (NAV), interval funds must incorporate the valuations from their underlying private real estate investments into their NAVs. Furthermore, the underlying private REITs generally fall under ERISA guidelines, thus their valuation process will typically involve the use of third-party independent appraisers. These two factors have a significant influence on a real estate interval fund's NAV. In other words, real estate interval fund NAVs are largely dictated by the valuations of the institutional private REITs in which they invest and not by the Fund's manager or sponsor. (If an interval fund holds a portion of assets in publicly traded REITs, then the closing price of these will also play a factor).

Non-traded REITs (NTRs) hold real estate properties directly and do not fall either under ERISA guidelines or the '40 Act framework. The NAV for NTRs is thus ultimately determined by the REIT's manager, which has more leeway in determining valuation assumptions for their real estate holdings. It is feasible the additional flexibility to determine NAV has resulted in smaller drawdowns for NTRs despite the significantly higher cost of debt and multiple commercial real estate indexes posting significant double-digit percentage declines. A recent article in the Wall Street Journal, brings more light to this topic; although higher NAVs today may appear more favorable in the current challenged environment, this may come at the expense of dampened future returns. A similar article, "Trouble with the Numbers" by Geoffrey Dorhmann, CEO of Institutional Real Estate Inc. in Real Assets Adviser Magazine raised similar concerns.[1] Dorhmann reports the reason that his firm will not report performance numbers is "…we know aren't comparable." He concluded, "It's a wacky world out there."

Advisors and due diligence officers should confirm in writing that the sponsor's valuations meet the NCREIF PREA reporting standards https://reportingstandards.info that are used by institutional investors.

Ultimately, real estate of similar quality, sectors, leverage, and categories (core vs core plus vs value-add) may likely experience the same appreciation in value over the medium to long term—that is, no single property persistently outperforms its comparable peers of the same property type and appreciates more in value. Similarly, funds (whether NTRs or interval funds) that have comparable sector and geographic exposure may likely converge in their long-term performance. Real estate interval funds that have recently experienced larger drawdowns may appreciate more during the recovery and converge with their NTR peers, which have seemingly navigated the current environment well but may be challenged in generating comparable returns upon market recovery.

[1] https://irei.com/publications/article/the-trouble-with-the-numbers-making-comparisons-between-performance-statistics-nearly-impossible/ (February 1, 2024)