LAKELAND CAPITAL

Investing in Individual Deals Over Funds Makes a Difference in Real Estate

Optimized cost control and closer alignment with investor preferences make individual deals the way to go

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Key Insights

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Fund managers need to extract higher returns just to match the performance of an individual deal due to expenses that are both costlier and more numerous.

Individual deals inherently motivate sponsors to be more mindful of downside risk and also tend to align better with investor preferences.

On-the-ground knowledge and deep local connections enable managers of individual deals to canvas a wider investment universe for higher quality opportunities.

Investors have increasingly turned to real estate to bolster their portfolios with a source of steady returns. Unlike with stocks or bonds, however, there is a wide range of ways to add exposure to the asset class.

Some channels offer direct exposure to real estate—like purchasing a multi-family apartment building—while others are more indirect—such as buying stock in a publicly-listed developer. Each channel offers different levels of return potential, liquidity and correlation with traditional asset classes. This creates an imperative for investors to understand the different options and identify the one that best facilitates their unique objectives.

To those who opt for direct exposure, the decision often boils down to buying into a real estate fund that has a portfolio of properties versus investing directly in individual properties with a professional investment manager. While each deserves careful consideration, we feel that the individual deal investment approach occupies a sweet spot that minimizes costs while also aligning more closely with investor preferences.

Fees Are More Numerous and Costlier Under Fund Approach

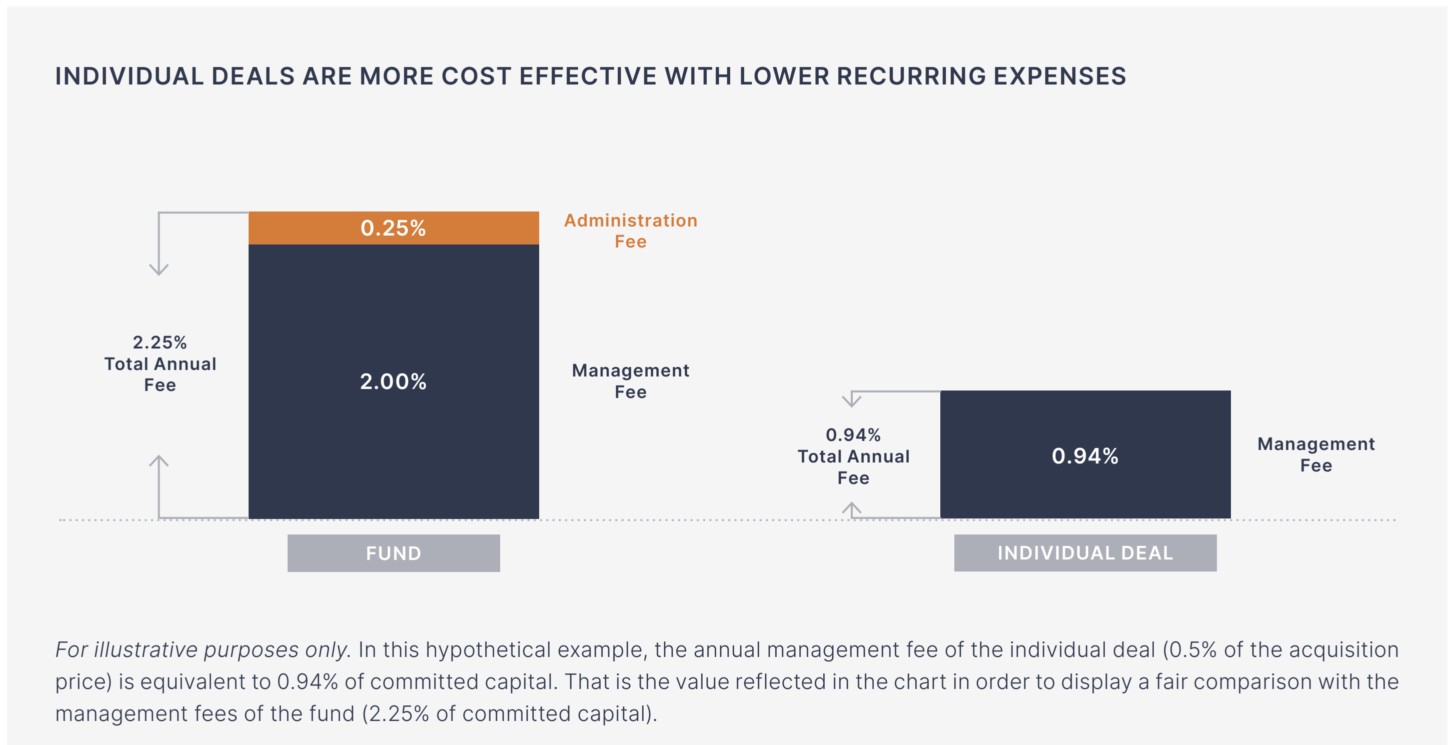
The decision to invest in a fund or in an individual deal should always include a close examination of the respective fee structures.

Turning first to the management fee, funds typically carry a significantly higher expense. This is best illustrated through a hypothetical example.

In this given scenario, the investment manager sponsors an individual deal charging a management fee of 50 basis points. It is applied annually against the acquisition price beginning when the property is purchased up through the sale date. For that same property, a fund charges a fee of 200 basis points on committed capital from the date of investment—a year earlier in this example—through the sale[1].

If we assume the investment has a five-year lifecycle, the total management fees accumulated by the fund would more than double those under the individual deal structure. Put another way, the fund manager would need to extract nearly 60 additional basis points in annual returns just to match the performance of the individual deal.

This is not the only material fee difference that investors should take note of either. Funds usually include annual administration costs of at least 25 basis points to support backend infrastructure components that serve the overall fund provider like legal, accounting and marketing. By contrast, administration fees to support fund infrastructure are not included under the individual deal structure.



For illustrative purposes only. In this hypothetical example, the annual management fee of the individual deal (0.5% of the acquisition price) is equivalent to 0.94% of committed capital. That is the value reflected in the chart in order to display a fair comparison with the management fees of the fund (2.25% of committed capital).

1. Hypothetical example assumes acquisition price of $75 million and equity investment of $40 million. Fund has 2% investment management fee incurred annually from Year 0 through Year 5 (total fee is $4.8 million); individual deal has 0.5% investment management fee incurred annually from Year 1 through Year 5 (total fee is $1.9 million).

Funds Face Additional Rebalancing Expenses

Real estate funds incur further costs through rebalancing. Funds periodically need to buy and sell properties to ensure that their overall portfolio continues to adhere to pre-specified investment guidelines regarding credit quality, diversification and asset value limits. This can result in high trading fees and unfavorable transaction prices that are ultimately passed on to the investor.

Unlike management and administration fees specified at the outset of an investment, it is not possible to anticipate rebalancing expenses. Rebalancing does not always occur at regular intervals. It can be particularly painful amidst market volatility when funds are forced by short-term requirements to dispose of troubled assets that may still have long-term potential.

Investing in individual properties, on the other hand, is unaffected by rebalancing since they are not part of a broader portfolio. Instead, it is a matter of course that the investment manager sponsoring the deal would make decisions solely intended to maximize the return from that specific property. We believe this enables the manager to be more nimble and take a longer-term view when volatility strikes or, conversely, capitalize once market conditions turn favorable.

We feel that it is also worth pointing out that investing in individual properties enables greater oversight on the underlying investment itself. While most funds certainly boast an array of due diligence protocols and risk management software that allows them to monitor their holdings, it is no match for an investment manager who has an intimate understanding of individual properties informed through extensive on-the-ground observations.

Individual Deal Approach Better Aligned With Investor Preferences

Extending the comparison of the two approaches beyond fees and running expenses, we believe that a clear line can be drawn between the incentives that drive the investment managers themselves.

In order to justify higher expenses, fund managers must set an ambitious return target. Importantly though, they are not generally required to provide additional capital or guarantees in support of an underperforming asset. Sponsors of individual deals, on the other hand, do carry certain liabilities. In our opinion, this creates an inherent motivation for them to be more mindful when considering the downside risk of a potential investment.

The location of the investment is another area where the individual deal approach tends to be aligned more closely with investor preferences. Investing directly in an individual property ensures that investors can choose their preferred market or exclude an undesired location, whichever the case may be. By contrast, funds are comprised of a portfolio of properties that may number in the hundreds or even thousands nationwide. The asset mix could also change significantly over time as the fund manager implements their particular strategy and also carries out any rebalancing efforts.

This should be a critical consideration for any real estate investor because market conditions can vary widely by location. Multifamily rents jumped nearly 6% in 2022 in Boston, for instance, which was double the rate of increase recorded in Phoenix[2]. In our view, this underscores how cities like Boston, which have a diversified economy and an entrenched housing market with barriers to entry, can expect to see steady rent growth. By contrast, faster growing areas in the country such as the Sun Belt might see more fluctuation from year to year.

Regardless of how an investor perceives the unique conditions and risk factors in a given market, they would only have the opportunity to implement their perspective through the individual deal approach.

2. Multi-Housing News. *2022 Rent Growth.* January 2023.

Wider Potential Investment Universe for Individual Deals

The potential investment universe is another factor that separates directly investing in individual properties from a fund approach.

Managers sponsoring individual deals typically limit their focus to a few key geographical sub-markets and can utilize connections with local brokers to target a deep pipeline of opportunities. A key part of their value proposition is being able to get the right property under contract at the right price.

Funds, on the other hand, have a much broader geographical reach but a somewhat shallower pipeline that tends to skew toward larger, more well-known properties. They also face a far more stringent time constraint to get properties under contract since they need to build a portfolio of holdings. This can force fund managers to be more aggressive in the underwriting and marketing of a transaction.

The two different approaches impact how investors are able to deploy their initial investment capital as well. Funds could typically put an investor's money to work almost immediately, owing to their considerable size and backend infrastructure. When it comes to the individual investment approach, however, it is more capacity constrained and may result in an investor having to wait until the investment manager is ready to announce a new opportunity.

What We're Watching Next

Discerning investors know that there are always trade-offs with any investment option.

Real estate funds offer a relatively seamless way to add exposure to the asset class without much diligence or administration required on the part of the investor. Opting for a one-size-fits all approach does come at a cost, however. Not only do funds incur additional fees but they also make regular portfolio changes which might not always be in the best interests of the investor or even aligned with their preferences.

The individual deal approach, on the other hand, provides a tailored option that is more efficient for a specific investment. While we firmly believe this is the optimal way to invest in real estate, we also acknowledge that there has been a proliferation of investment managers in this arena.

That is why we feel it is vital for investors to find a trusted manager who has both the on-the-ground presence and vision necessary to chart a long-term path which can achieve their unique investment objectives and navigate through any challenging market environments along the way.

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