Navigating the Space between “Direct” and “Indirect” Real Estate Investing
PERSPECTIVE FROM FRANKLIN REAL ASSET ADVISORS®

KEY POINTS
- Global real estate, as an asset class, has evolved past the stark distinction between “direct” and “indirect” real estate investment.
- Investors are seeking increased transparency, greater control and lower cost in their real estate portfolios.
- These benefits are potentially available through a new and developing universe of local partners, who offer a range of investment opportunities on the continuum between “direct” and “indirect.”

Introduction
With the continual evolution of private real estate as a mainstream global asset class for both institutional and individual investors, we see increasing complexity in the range of strategies, risk/return classifications and investment structures investment managers are offering. We believe this complexity may potentially confuse investors, particularly those new to the asset class.

More specifically, we see an outdated distinction between “direct” and “indirect” real estate investing being drawn, which may confuse investment strategy with investment structure.

In this paper, we argue that in today’s market a continuum of investment options is blurring the delineation between “direct” and “indirect” real estate investment, offering investors the potential for an unprecedented degree of control over real estate portfolio construction.

What Do “Direct” and “Indirect” Mean Anyway?
The definition of “direct” real estate investment has evolved considerably over the years as the asset class has grown and developed.

Originally, in a so-called “direct” real estate investment, an asset such as a building or piece of land was wholly-owned in the name of the investor, without the involvement of third parties or intermediaries.

This was the starting point for institutional investment in real estate in the 1970s and ‘80s, when corporations, banks and insurance companies would own properties and maintained substantial internal teams to handle the myriad day-to-day property management tasks, such as leasing, rent collection and maintenance.

As pension funds and other institutional investors began to invest in real estate, they discovered that direct investment was resource intensive, difficult to pursue as a strategy outside their home market (due to cultural differences and tax and regulatory complexities) and resulted in significant concentration risk within the real estate portfolio. Large, single assets in the same geographic locations typically dominated the portfolio’s risk profile.

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In the mid- to late-1990s, investors began to access global real estate using private real estate funds, which became the predominant private real estate investment vehicle until the global financial crisis in 2008–2009.

These traditional “blind-pool” private real estate funds are clear-cut examples of an “indirect” investment. Here, an investor commits capital to a fund manager, who then makes several smaller commitments to real estate investments, which local
operating partners manage. The manager essentially allocates capital to these operating partners who then are responsible for investing in real estate assets, and are paid fees from the investors’ capital. While significantly more diversified than a “direct” investment, under the “allocator” model, the ultimate investor appears to be several steps further removed from the real estate asset.

The Distinction Begins to Break Down

During the turmoil of the financial crisis, some private real estate funds experienced volatility and unexpected capital losses. The crisis showed that the way in which some funds were structured provided neither an adequate mechanism nor the means for the manager and investors to actively preserve value.

These issues led some investors to shun “blind pool” funds in favor of “direct” investments, believing directly owning real estate assets would provide the relative benefits of increased transparency, greater control and lower cost.

However, the same challenges that led investors away from “direct” investing persisted; investors were unable to gain exposure outside their home markets and resources were constrained, meaning that outsourcing arrangements again needed to be considered.

As an example, consider a large sovereign wealth fund that invests in real estate around the world. Are their transactions “direct” or “indirect”? In practice, outside of its home market the sovereign wealth fund is making “sponsor-led” transactions, using local operating partners in a similar way to the manager of an allocator fund. While in some cases they may wholly own the assets, in others the investment is shared with the local partner or with other investors, and third parties are responsible for the on-the-ground work. These third parties are able to utilize their local market knowledge to create attractive investment opportunities. The investor potentially benefits from this outside expertise in a way in which they could not were they to insist on performing all functions in-house.

In practice, then, large, “direct” institutional investors, like the aforementioned sovereign wealth fund, routinely partner with local experts and various third-party service providers to source, acquire, manage and dispose of real estate assets in executing their global investment strategies. This approach affords them the possibility of flexibility and scalability in building their real estate portfolios, as well as a potentially cost-efficient use of resources as they may benefit from the economies of scale third parties can offer. They are also able to select and access the appropriate expertise and skill-set to match what is required for a particular transaction or investment strategy.

At the same time as large institutional investors’ use of local partners is eroding the distinction between “direct” and “indirect” investment, these local partners, as a group, are raising real estate funds of their own.

These “emerging manager-sponsored” real estate funds are relatively small in size, more targeted at specific geographies and property sectors, and can offer significant influence to investors able to seed them with capital. Sometimes this approach can lead to a “fund of one,” where capital is raised from a single investor. In these cases, while day-to-day decision making is still delegated once the fund is investing, the original investor can exercise substantial control in the initial structuring of the transaction by setting tightly specified investment restrictions, timeframes and governance provisions. The ability to set initial terms allows investors to underwrite a seed portfolio as they would if they were considering purchasing it outright, potentially offering a degree of transparency that is not available in “blind pool” indirect funds.

These emerging managers are often also willing to provide investors with attractive fee arrangements as compared to what larger, more established ones offer.

This is what leads us to suggest that, perhaps, with the exception of the very largest investors, the stark distinction between “direct” and “indirect” real estate investment is a relic. Instead, “direct” and “indirect” investments are situated on opposite ends of a broad spectrum, with many investment options currently available in between.

Therefore, we would suggest that investors abandon a focus on the distinction between “direct” and “indirect” investment structures, and instead concentrate on their investment objectives when deciding how best to gain the desired global real estate exposure for their portfolios.
In both of these cases, while third parties are involved to a significant degree, layers of intermediation have been eliminated. A more streamlined structure potentially improves the overall cost of the transaction and we believe leads to a more efficient use of resources.

**Conclusion**

In the outmoded binary distinction between “direct” and “indirect” real estate investments, we believe investment strategy can oftentimes be confused with investment structure, to the detriment of investment outcomes.

With a complex array of investment strategies available to today’s private real estate investor, and the multitude of investment structures in which they might be housed, it may at first appear a daunting prospect to address this complex universe and build a truly diversified global private real estate portfolio.

For investors who have the in-house resources and expertise to navigate the complexity of global private real estate, we recommend focusing on the desired investment strategy and level of diversification. These investors should seek out third parties with the requisite expertise for the strategy in question and conduct the necessary due diligence to ensure an appropriate governance, compensation and control structure that aligns both parties’ interests regardless of the investment structure.

For investors that lack these in-house capabilities, partnering with an experienced investment advisor with global reach and access to local expertise can seek to extract the maximum value from what is a rich universe of potential private real estate investment opportunities, while attempting to avoid potential pitfalls along the way.

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**Investing In the Space between Direct and Indirect**

We observed earlier that, in expressing a preference for “direct” real estate investments, investors were seeking increased transparency, greater control and lower cost.

These are laudable aims and, as we have noted, in the pre-financial crisis landscape of mostly blind pool, “allocator” private real estate funds, these characteristics were generally not readily available to all but the very largest investors.

In the current environment, however, it is possible to access real estate investments with third-party managers and operators that offer investors the possibility of a greater degree of influence, transparency and control over key aspects of investment decision making without necessarily incurring additional expense.

For example, as we highlighted, for an investor willing to do the additional due diligence required, a relationship with an emerging manager can yield significant influence over the terms and mandate of a fund investment. This kind of relationship can also offer the right to co-invest alongside that manager’s fund in specific transactions where the investor can underwrite assets directly and have influence over decisions regarding the business plan or ultimate sale of the assets. These co-investment transactions can be used within diversified portfolios to increase specific investment exposures generally at a lower cost and with greater control than through “indirect” investments.

Club deals with other investors, where a manager is hired to perform specified tasks but the investors exercise collective decision-making powers; or joint ventures directly with real estate operating partners, where the investor has the controlling equity stake but the operating partner is executing the asset-level business plan, are other investment types that lie somewhere between “direct” and “indirect” investing, and can offer greater control and transparency than might be found in “indirect” investments.
WHAT ARE THE RISKS?
All investments involve risks, including possible loss of principal. The risks associated with a private equity real estate strategy include, but are not limited to various risks inherent in the ownership of real estate property, such as fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by general and local economic conditions, the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, environmental laws, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). Real estate securities involve special risks, such as declines in the value of real estate and increased susceptibility to adverse economic or regulatory developments affecting the sector. Investments in REITs involve additional risks; since REITs typically are invested in a limited number of projects or in a particular market segment, they are more susceptible to adverse developments affecting a single project or market segment from more broadly diversified investments. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments.
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