ORIGIN
INVESTMENTS

WHY EVERY INVESTMENT PORTFOLIO NEEDS PRIVATE REAL ESTATE

A GUIDE FOR ACCREDITED INVESTORS

INTRODUCTION

Private real estate is an important part of a diversified investment portfolio. Yet it's been difficult for individuals to access the best investments in this asset class; traditionally, they've been offered first to institutional investors such as pension funds and endowments, or the ultra-wealthy, through wealth advisors and friends.

Today, that's changed. Individual investors have far more opportunities to access private real estate than ever before — from public and private REITs to a growing flood of crowdfunding platforms made possible by the Jumpstart Our Business Startups Act in 2012. It should now be easier for individuals to assemble a portfolio of private real estate investments, presumably applying the same principles used in their stock and bond portfolios. But it doesn't always work that way. Private real estate is still a complicated and unfamiliar asset class for many, especially considering the many opportunities investors have today.

This guide explains how private real estate benefits portfolios; identifies common real estate investing strategies; explains the different types of risk involved in the process; and shows investors how to start investing in private real estate today.

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PRIVATE REAL ESTATE BENEFITS

Private equity real estate investing is direct ownership of physical real estate — whether it's in the form of land, office buildings, rental homes, apartments, shopping centers, hotels, self-storage facilities and so on — with the intent of making a profit. Ownership means an equity stake in a piece of property. Individuals can invest in private real estate by acquiring assets actively as a direct buyer, or by investing passively with a private real estate investment firm, an online platform and/or in a non-traded private REIT.

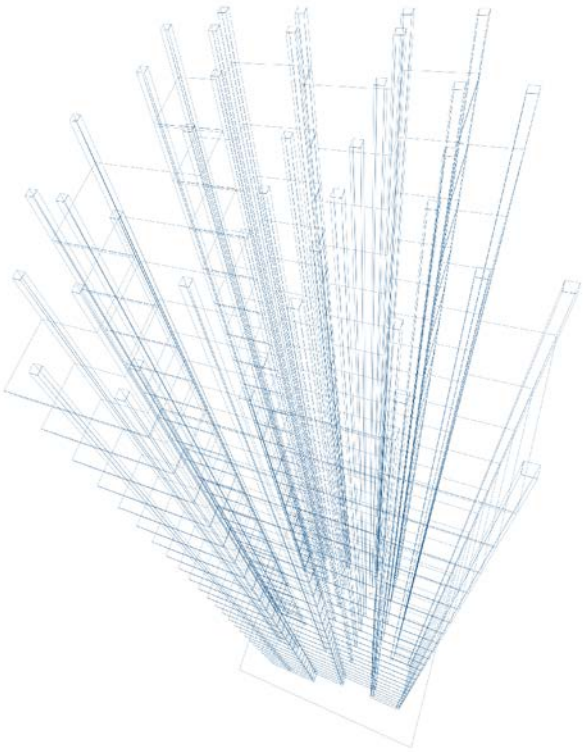
Private real estate offers many benefits to individual investors, such as high returns, portfolio diversification and tax efficiency. Institutional investors have long understood the merits of this asset class and relied on it in their portfolios to balance market uncertainty. Take Yale's endowment — considered the gold standard for its exceptional performance; **10% of its investment portfolio is allocated to real estate**. Not surprisingly, most endowments and pension funds follow a similar investment plan. But individual investors have only begun catching on to this strategy and started **adding private real estate to their portfolios in the last few years**.

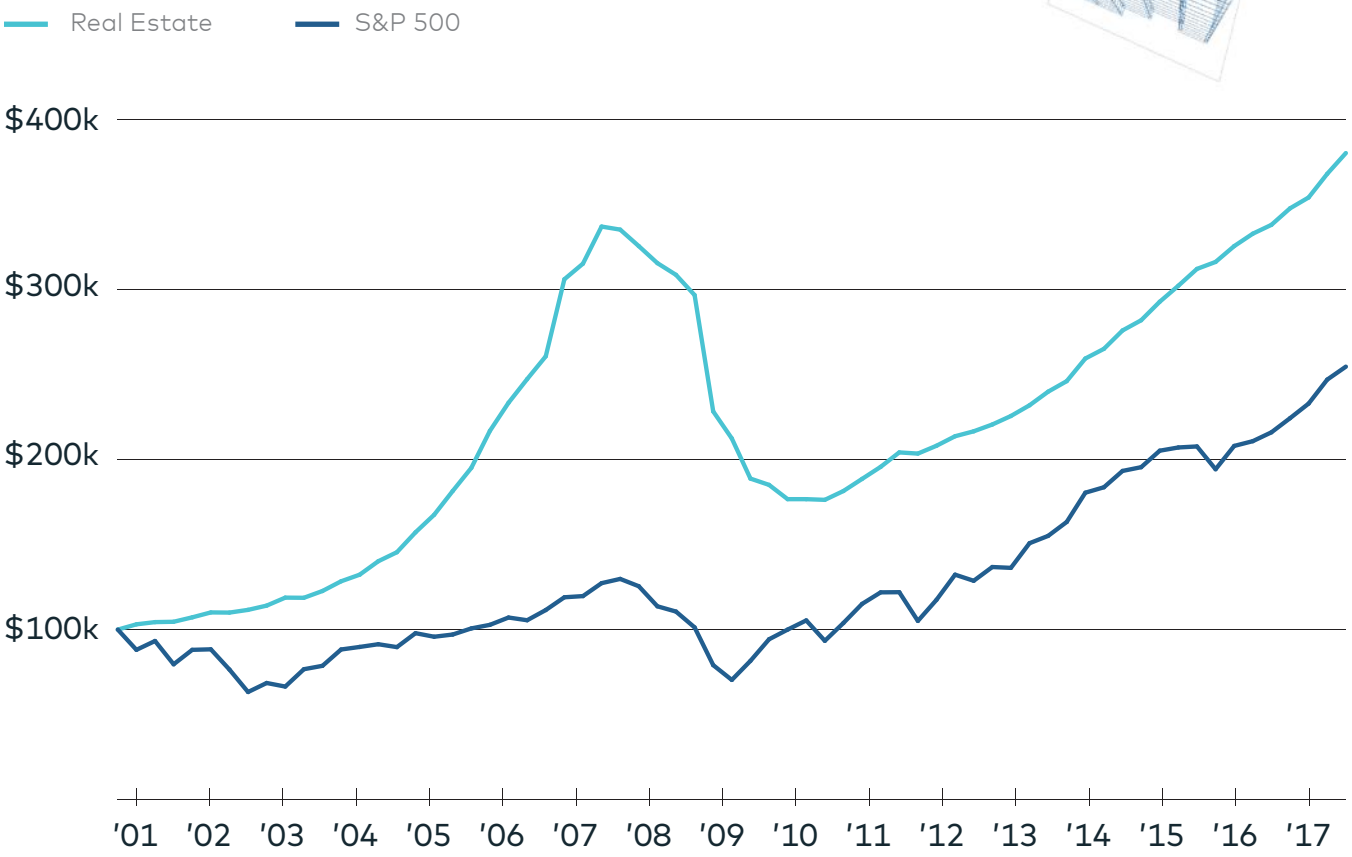
> *Yale's endowment, considered the gold standard for its exceptional performance, allocates 10% of the $27 billion of assets in its investment portfolio to real estate.*

BENEFIT #1

PRIVATE REAL ESTATE GENERATES HIGH ABSOLUTE RETURNS

Private real estate offers investors the ability to generate high absolute returns. An absolute return takes into account appreciation, depreciation and cash flows to measure the amount of money an investment earns over time, and is expressed as a percentage gain or loss on the initial investment. Looking at data from Preqin, a research company that tracks the performance of alternative investments, a $100,000 investment in private real estate beginning on January 1, 2001, would have been worth about $380,000 on March 1, 2017. That same $100,000 investment in the S&P 500 would be worth $255,000 on March 1, 2017, as depicted in the chart below.





(* Preqin data)

BENEFIT #2

PRIVATE REAL ESTATE HAS LOW CORRELATION TO OTHER ASSET CLASSES

The goal of every portfolio is to create the highest total return with the least amount of volatility. Most investors are comfortable with a mix of stocks and bonds in their investment portfolios — until the markets' ups and downs start making them nervous. Private real estate helps investors temper the volatility in their portfolios because it's immune to the daily shocks of trading.

The value of a private real estate fund is based on the actual value of property held by the fund. Conversely, in a public REIT, the share price value is determined by daily market forces, which means the share price of a public REIT may not reflect the actual value of the underlying real estate. In some cases, the share price can value the REIT 30% higher or lower than the actual value of the underlying real estate.

Private real estate values don't move much on a daily basis but rather appreciate slowly over time, which is why private investments are less volatile than their public counterparts. Both vehicles have pros and cons and the optimal portfolio has a combination of both. Public markets offer liquidity, but that comes at the expense of volatility and private investments offer investors low volatility, but with that comes illiquidity.

The chart below illustrates how private real estate has **minimal correlation to stocks, bonds and even public REITs**, as measured by the National Council of Real Estate Investment Fiduciaries (NCREIF) property index (NPI), which looks at the returns of private institutional grade commercial properties.

A **correlation coefficient** of 0 means that price fluctuations are not correlated at all. A correlation coefficient of 1 means that assets move together in tandem and a negative correlation means that they move in opposite directions to one another. An investment portfolio benefits greatly when it includes asset classes that are not correlated to each other.

	RUSSELL 3000	BARCLAYS U.S. AGGREGATE	NAREIT
NCREIF Real Estate	0.23	-0.24	0.13

(TIAA-CREF Asset Management)

BENEFIT #3

PRIVATE REAL ESTATE IS TAX EFFICIENT

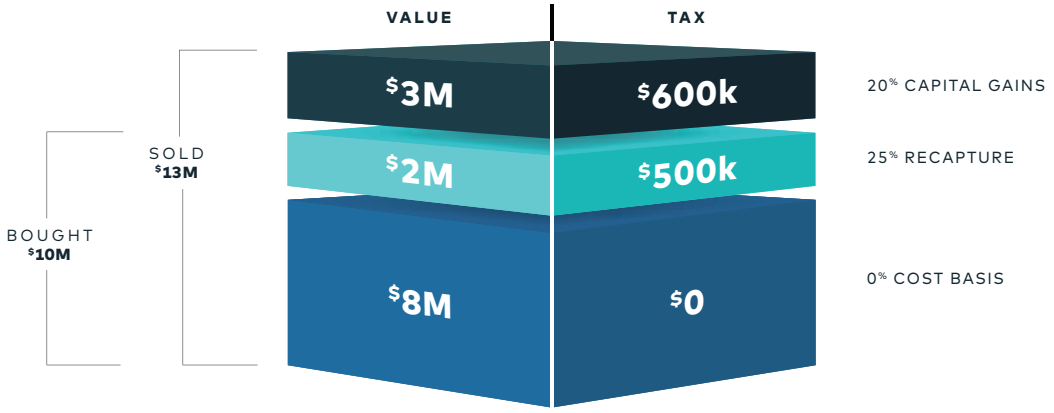
Investors who focus solely on an investment's underlying returns and ignore its after-tax yields don't recognize a big benefit of real estate investing. Income generated by properties is generally shielded through depreciation, providing investors with the long-term benefits of substantial cash flow and very little tax burden.

IRS rules allow owners to take annual losses in the form of depreciation to smooth out eventual capital expenditures as buildings age. However, only the physical elements of a property are subject to depreciation. Land can't be depreciated, and must be separated from the physical property value. For example, a multi-family property can be straight line depreciated over 27.5 years. If the property was acquired for $6 million and sitting on land worth $1 million, it will produce $181,818 in annual non-cash depreciation. This is calculated by dividing $5 million by 27.5 to yield $181,818.

In general, individuals will pay between 20% and 25% in taxes on real estate investments versus 37%, the highest tax bracket on ordinary income, for hedge funds and other alternative vehicles. So if a property generates $100,000 of cash flow and $50,000 in depreciation, then the taxable income to the individual will only be $50,000. The tax liability, assuming an investor is in the highest federal tax bracket, is calculated by .37 x $50,000 to yield $18,500, which is the equivalent of an 18.5% tax rate on the entire cash flow of $100,000.

However, the depreciated portion of the property is subject to a recapture rate of 25% upon sale. Here's how it is applied: if a property were acquired for $10 million and depreciated by $2 million, the cost basis for tax purposes would only be $8 million. The difference between the cost basis and the original purchase price is taxed at the recapture rate upon sale.

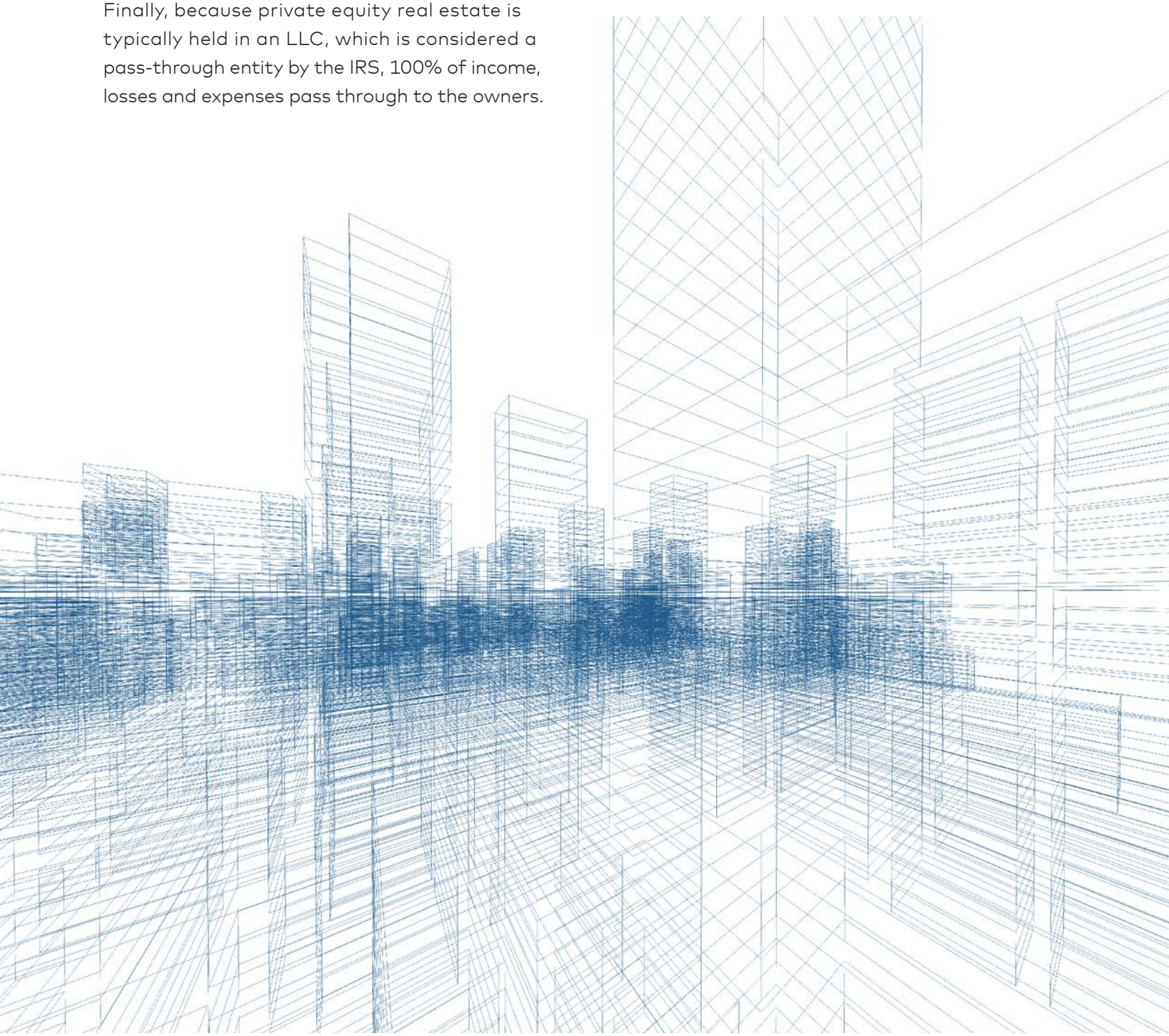
Additionally, any investment appreciation above the original purchase price, assuming the property has been held for more than one year, will be subject to the long-term capital gains rate of only 20%. Expanding on the example above, if the property were sold for $13 million, the difference of $2 million from the IRS tax basis of $8 million to the purchase basis of $10 million would be subject to the recapture rate of 25%. The gain from $10 million to $13 million would be taxed at the capital gains rate of 20%. The effective overall tax liability at sale would be $500,000 + $600,000, or $1.1 million. The diagram below details how this works.



Another tax benefit of real estate is the ability to defer taxes indefinitely through a 1031 exchange. The **1031 exchange** tax provision allows real estate owners to sell a property and buy another property without incurring capital gains taxes. In theory, an investor could buy and sell properties without ever paying taxes on the gains. The ability to defer taxes into the future is one of the greatest attributes of owning real estate directly.

Finally, because private equity real estate is typically held in an LLC, which is considered a pass-through entity by the IRS, 100% of income, losses and expenses pass through to the owners.

Unlike corporations, where owners may be subject to **double taxation** (the corporation pays taxes on corporate net income and the owner pays on any dividend income they receive), the LLC itself does not get taxed. Instead, individual members are taxed on their share of the income, expenses and losses reported on their **year-end tax document, the K-1**. They are taxed at their tax rate, which is often lower than the corporation's.



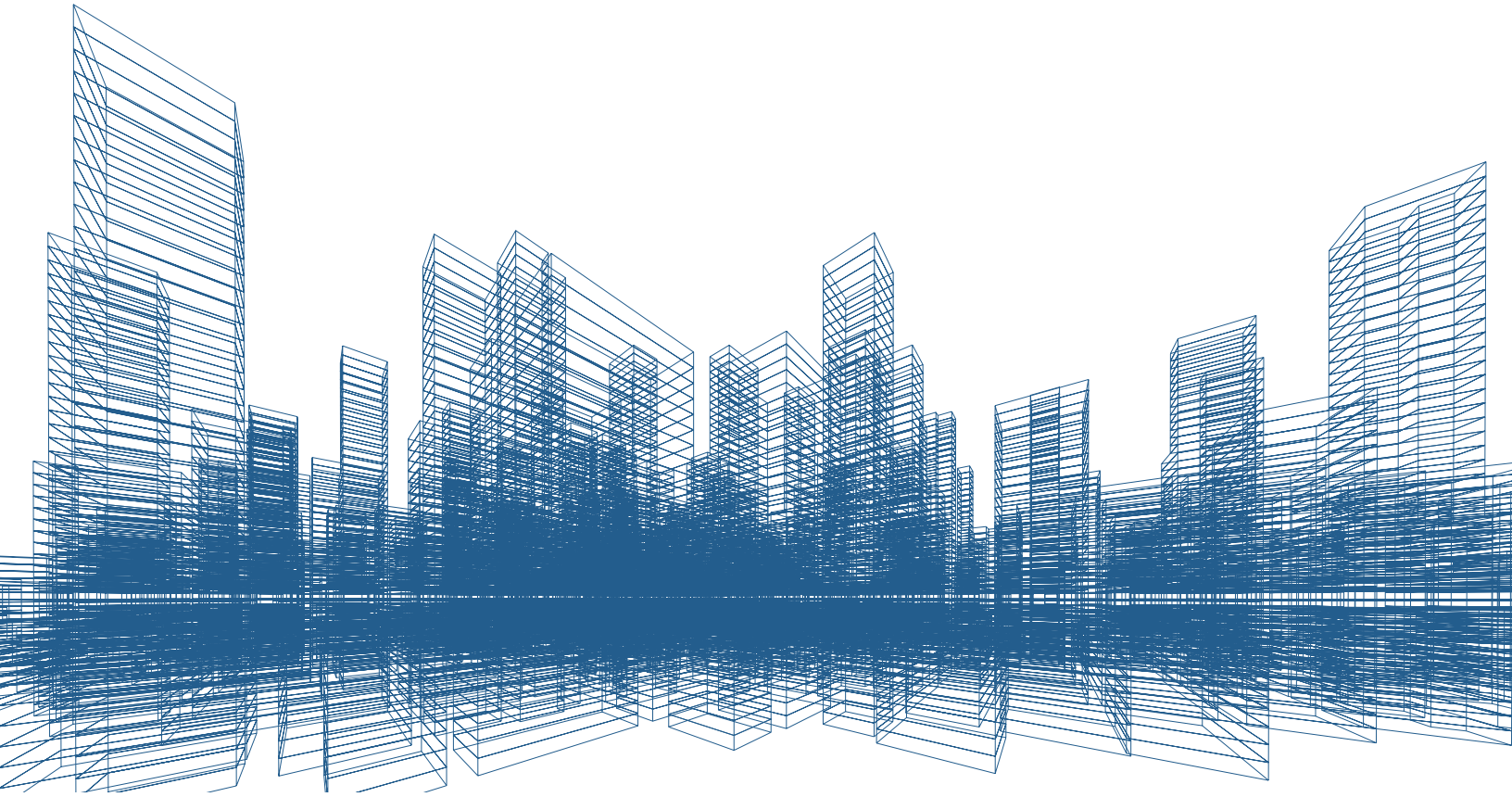
ACTIVE VS. PASSIVE PRIVATE REAL ESTATE INVESTING

Active investing is when buyers own and operate an asset outright, either by themselves, or with family, friends or acquaintances. They can make swift decisions and take advantage of opportunistic ventures because usually they are making decisions alone or with a limited number of partners. However, given the substantial capital and expertise required to acquire and operate investment-grade commercial real estate, there are high barriers to entry for buyers.

Acquiring property alone isn't impossible, but along with this option comes a lot of work and responsibility. The investor or owners will need to source the property, negotiate the price, obtain financing, collect rent, handle repairs and maintenance and manage the daily activities, from garbage disposal to renting vacant units. These responsibilities are amplified when making the multiple investments needed to build a diversified portfolio of properties — especially when further capital is necessary for tenant improvements, leasing commissions and renovation costs.

Unfortunately, in many cases investors don't have the necessary expertise and unwittingly buy real estate assets that require more time, resources, renovation and maintenance than originally expected. They may not have developed the right business plan to make the investment profitable, or have focused on too few assets to build a diverse real estate portfolio. Or they may be exposed to unlimited risk through liability and debt guarantees.

Passive investing is when an investor chooses to outsource their real estate investments to a manager, and pays them a portion of the profits for their services. Managers pool money from numerous investors to buy larger or whole portfolios of properties, and run all of the day-to-day operations for these assets. They acquire



the properties, execute the business plans and report to investors. In this case, individuals are still direct owners in the underlying properties and receive all of the benefits.

There are several different types of companies that offer passive real estate investing opportunities. Investors can choose a private equity real estate firm, an online crowdfunding platform or a non-traded private REIT. With these options, the real estate is typically held in a Limited Liability Company (LLC), which protects investors from the potential unlimited liability associated with owning a physical asset in the event of a lawsuit or some other unforeseen event.

WHO CAN INVEST IN PRIVATE REAL ESTATE?

Generally, private real estate investing is only available to accredited investors, a regulation set by the federal government. However, some managers utilize a Reg A+ vehicle that allows non-accredited investors to participate in private real estate for as little as $500.

Individuals meeting one of the following criteria qualify as accredited investors:

- Individual net worth, or joint net worth with their spouse, that exceeds $1 million (excluding the value of their primary residence);
- Individual income exceeding $200,000 in each of the past two years and the expectation to reach the same level this year;
- Combined income with their spouse exceeding $300,000 in each of the past two years and the expectation to reach the same level this year;
- Investment responsibility on behalf of a business or investment company with more than $5 million in assets and/or equity owners whom are all accredited.

REAL ESTATE STRATEGIES AND RISK LEVELS

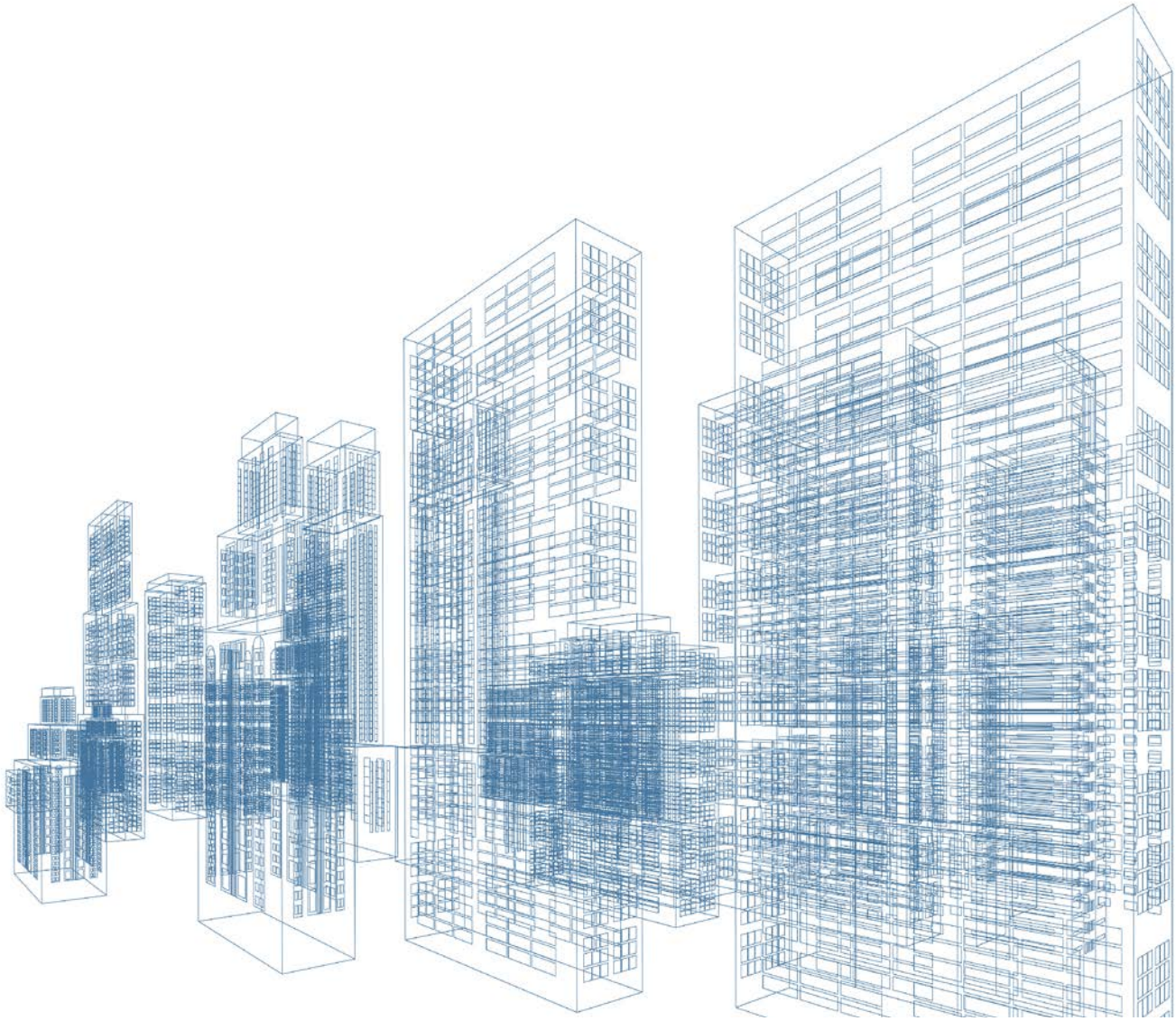
Private real estate investors should consider the level of risk they're willing to take to achieve their investment goals, and how long they are willing to wait before they begin receiving returns. Some investors may focus completely on long-term gains that have promising yields but little to no liquidity, while others may want to generate steady income that will offer more frequent dividends.

To achieve these investor goals, real estate operators focus on four main types of real estate strategies: Core, Core Plus, Value Add and Opportunistic. Each fall at a different point on the risk vs. return spectrum and require different types of leverage, since debt has a direct **impact on the level of risk an investor faces**. The risk of each type of investment and its relationship to leverage is explained in the chart below.

CORE	Core investments are considered the least risky because they involve stable, income-producing properties that are in prime locations in major markets; have no structural issues; and enjoy full or high occupancy with high credit tenants on long-term leases. These are Class A properties with steady income streams. For a landlord, what's not to like? However, thanks to their desirability, these types of investments warrant low leverage — typically between 30% and 50% — and are a perfect fit in a blue-chip portfolio that delivers a steady stream of income. The role of these core assets is to behave like a high-yield bond with little downside risk to principal. Typical returns in this sector are around 6–8% annually. The offset to this stability is that these types of investments generally do not offer much potential for growth.
CORE PLUS	Core-Plus investments are held for both income and growth, and while they are similar to Core properties, they have more potential for upside appreciation. For instance, a property may have a high proportion of leases up for renewal. While Core investors see this as a threat to steady income, Core-Plus investors might see this as an opportunity to increase rents and increase yield. Returns for Core-Plus are around net 9–12% annually and they are typically leveraged between 40–65%.
VALUE ADD	Value Add holds the middle ground between conservative Core and high-risk Opportunistic investments. Investors looking to take on more risk to achieve high returns, and are willing to defer gains, should invest in either Value Add or Opportunistic properties, which may require improvements and require more complex business models to achieve higher returns. Nearly all of the Value Add investor's return will come in the form of appreciation, with no expectation of cash flow for at least 24–36 months. Value Add properties may have operational issues and require physical improvements due to a prior owner's neglect, or need improvements that a prior owner lacked the capital to make. Value Add investments have the potential to be more lucrative than Core or Core-Plus strategies with the right kind of physical upgrades, better management, added services or more effective marketing. The targeted returns for a Value Add property average 13% to 18% annually, and they are typically leveraged between 60–75%.
OPPORTUNISTIC	Opportunistic investments are on the far end of the risk spectrum, and cover the broadest range of properties. These deals can involve buildings that require massive turnarounds of an existing property, adaptive reuse or even new ground-up development. The unifying strategy is that investors are willing to take outsized risks and put in higher upfront costs to achieve outsized returns. Ironically, Opportunistic new construction projects might eventually deliver Core properties that attract high-profile tenants. However, getting there takes years of labor, management-intensive development work and substantial market risk before the first rent checks roll in. Given these risk characteristics, there is typically a very high return threshold to meet before an investor should consider making Opportunistic investments. For instance, these investments are typically leveraged 70% or more, though they can generate returns in excess of 20% — if they are successful!

The matrix below helps guide investors on which type of private real estate investments may make the most sense, based on risk tolerance and time horizon.

	RISK TOLERANCE LEVEL		
TIME HORIZON	**CONSERVATIVE**	**MODERATE**	**AGGRESSIVE**
0–5 years	Core	Core	Core Plus
5–10 Years	Core	Core Plus	Opportunistic/Value Add
10–20 Years	Core Plus	Core Plus/Value Add	Opportunistic/Value Add



HOW MUCH OF YOUR PORTFOLIO SHOULD BE IN PRIVATE REAL ESTATE?

The old saying "don't put all your eggs in one basket" applies to real estate, as well as markets. Private real estate is cyclical in nature and goes up and down over time just like stocks and bonds, but not on a daily basis. For that reason, it is called illiquid, which means an investor's capital may take months or years to unlock, so it is not an option for those who need that capital in the short-term for living expenses or college tuitions.

However, that hasn't stopped investors from buying into this lucrative asset class. A Tiger 21 survey cited by Bloomberg showed that high-net-worth investors representing $51 billion in assets had an average of 33% of their portfolios in private real estate investments. But the ideal allocation truly depends on each Individual's situation, which is a combination of their net worth and time horizon.

For example, a family office worth $300 million may be fine with more than 50% of their investable capital in illiquid assets, while an accredited investor with $1 million in investable capital may not feel comfortable having any capital in illiquid assets. On the flipside, an investor may be perfectly comfortable with a large illiquid position in their retirement account, but not in their personal savings account, which they may need to tap into at a moment's notice. Illiquidity is something that has to be managed appropriately. The question to ask is how much liquidity should be reserved for an emergency?

The illiquidity that comes from private real estate investing isn't necessarily a bad thing, as long as an investor has enough savings to use for emergencies. One of the most common bad investing decisions is precipitated by panic when

the market turns south. The pain of a stock market crash is so great that investors flee at the bottom, which is precisely the time they should stick with it.

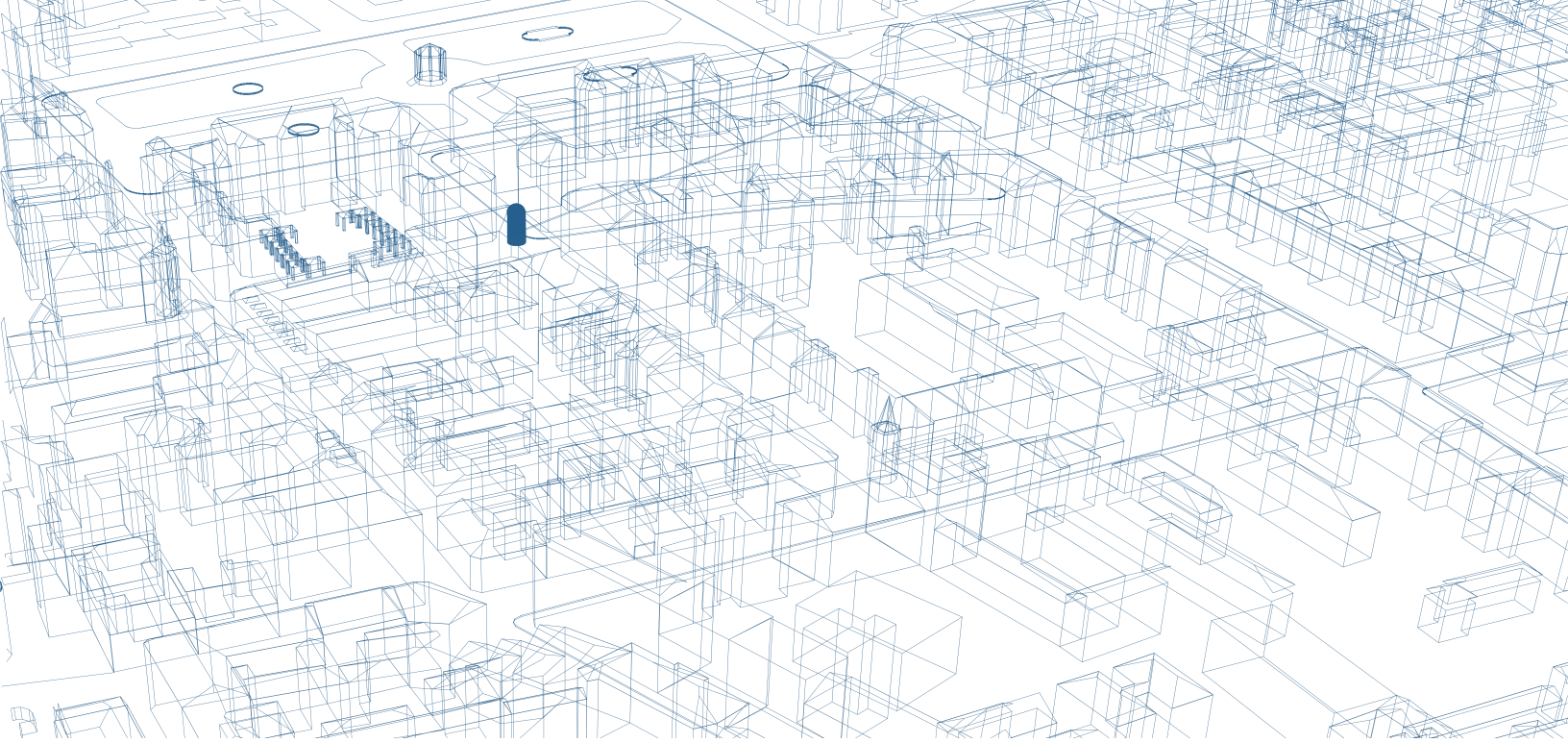
Solid evidence substantiates this point. In "Why Smart People Make Big Money Mistakes and How to Correct Them," co-authors Gary Belsky and Thomas Gilovich pointed out that "by pulling your money out in short-term stock market drops, you run the risk of missing the productive days." And those productive days add up. They did the math: "If you missed the 90 best-performing days of the stock market from 1963 to 2004, your average annual return would have dropped from almost 11%... to slightly more than 3%."

It turns out that amounts to big bucks. According to the co-authors' calculations," on a $1,000 investment, those different rates of return translate into the difference between having $74,000 after four decades and having about $3,200." It brings to mind another benefit of real estate investment: illiquidity can stave off knee-jerk decisions brought on by panic.

The matrix below helps guide a potential private real estate investment allocation, based on net worth and time horizon.

PRIVATE REAL ESTATE ALLOCATION GUIDELINES

TIME HORIZON	NET WORTH			
	1–5 Million	5–10 million	10–25 million	25 million+
0–5 Years	5%	10%	15%	20%
5–10 Years	10%	15%	20%	25%
10–20 Years	15%	20%	25%	30%



GETTING STARTED WITH PRIVATE REAL ESTATE INVESTING

How much time and effort do you want to put into real estate investing? That's the first and most important question an investor should consider when deciding to invest in private real estate. If they have deep market knowledge, the time to find properties and the ability to execute a business plan by improving and managing properties, they can build their own portfolio of individual real estate deals. Or they can invest in a diversified real estate fund. There are pros and cons to each approach.

Individual Real Estate Deals: Many websites offer access to individual deals such as RealCrowd and Crowdstreet. These platforms act as the middleman between the investor and the real estate operator. Many investors choose this option because they simply prefer the control they have in picking their own deals versus trusting the process to a manager.

Private Real Estate Funds: Funds, such as the ones we offer at Origin Investments, usually include multiple deals, each with its own business plan. This offers individual investors diversification. An investor may have the resources to buy a few buildings, but by investing the same money in a well-run private real estate fund, they get stakes in many deals that they don't have access to on their own, and have knowledgeable professionals do the due diligence on each property. These can range from apartment buildings to industrial complexes, and can be located in many cities at once to take advantage of thriving market conditions. Owning multiple properties also limits risk; if one property underperforms, it doesn't impact the others and drag down profits across the board. Individual deal investments do not offer this same benefit. If a deal fails, investors suffer substantial loss.

Additionally, well-run funds are structured to align interests between the manager and investors. For instance, some fund managers invest their own funds alongside those of their investment partners, or use a pay-for-performance structure to pay management. However, finding the best private real estate fund is complicated to navigate. The best place to start would be to ask a wealth manager, but

regardless, it's still critical for investors to do their own due diligence on every deal, fund and manager they hope to use. The choice of a private manager can mean the difference between doubling an investment or a total loss. The most important decision in real estate investment is the selection of the investment manager.

To separate the good managers from the bad, investors should ask them the following questions before making an investment:

- What's the manager's financial stake? The manager should have **real skin in the game**.
- Does the manager have a team? Bigger isn't always better. But private real estate is a high-touch industry, so there should be dedicated departments handling property acquisitions, asset management, accounting, investor relations, etc. And if a manger has investments in different regions of the country, they should have "**boots on the ground**" to provide deep market expertise.
- Are there any potential conflicts of interest? Does the manager employ any in-house construction or property management teams that could hamper the asset management team's decisions? For instance, a manager may not sell a property at the most advantageous time if it means finding new jobs for an in-house property management team.
- How are fees charged? Look for a **fee structure that is transparent, and largely performance-based** so the manager wins only if the investor wins.
- How strong is the balance sheet? The balance sheet should indicate if the manager has the capital to fulfill its obligations over the long run.
- What is the manager's track record? Managers should have at least ten years of successful experience in the industry.

EDUCATIONAL RESOURCES FOR THE PASSIVE REAL ESTATE INVESTOR

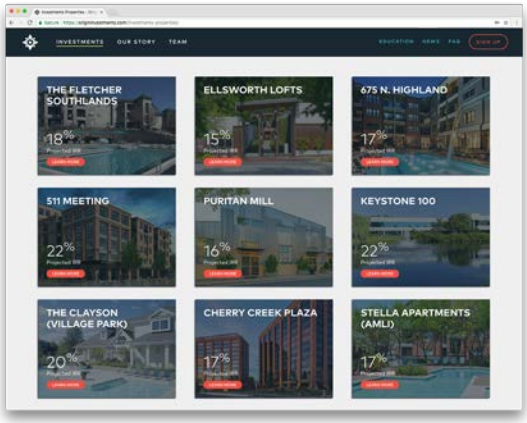
Origin Investments provides articles, newsletters and guides to help individual investors make smarter private real estate investing decisions. View more educational resources at **origininvestments.com/blog.**

Other Resources:

- A Student of the Real Estate Game offers information on how to invest passively in real estate, from an acquisitions manager at a private investment firm;
- White Coat Investor provides information on real estate investing for doctors, from the perspective of a doctor;
- 506 Investor Group is a group of accredited investors who share information on real estate investments;
- Investor Junkie compares the largest real estate crowdfunding websites;
- National Real Estate Investor provides the latest news on the commercial real estate industry.

ABOUT ORIGIN INVESTMENTS

Origin Investments is transforming the way individuals invest in commercial real estate. We invest side-by-side with investors, adhere to a disciplined investment philosophy, and use technology to make it easy to manage investments. Origin's first two funds are averaging a 24% net return to investors and have achieved top quartile performance, per Preqin data. We recently raised over $150 million for Origin Fund III.



Sign up at OriginInvestments.com to explore our investment opportunities.

ABOUT THE AUTHOR

Michael Episcope

Principal and Co-Founder

Michael is Origin's principal, co-chairs the Investment Committee and oversees investor relations, marketing and company operations. He brings 25 years of investment and risk management experience to the company, and believes that calculated risk-taking in inefficient markets is the key to building wealth.

He frequently shares his knowledge with individual investors on Origin's blog, Forbes, ValueWalk and Huffington Post, and his expertise has made him a frequent speaker on real estate investment panels and podcasts.

Michael learned about the physical aspects of real estate in his youth as he helped his grandfather manage his apartment buildings on Chicago's West Side. He began college at DePaul University and a year later was introduced to the floors of the Chicago Mercantile Exchange. He continued to work full time on the trading floor for the next 16 years while attending night courses to complete his undergraduate degree. After rising from runner to broker, Michael was given an opportunity to become a floor trader by a Chicago based hedge fund, Tradelink, LLC, and then enjoyed a prolific nine-year trading career. Trader Monthly Magazine named him one of the top 100 traders in the world twice.

In 2005, with two children and a third on the way, Michael cashed in his chips and retired from trading. His new focus was in managing the wealth he had accumulated. He enrolled in a master's program in real estate at DePaul and co-founded Origin Investments two years later with **David Scherer**.

Michael is the former president of the DePaul Real Estate Alumni Alliance and a sustaining sponsor of the DePaul Real Estate Center. He has been a Vistage member for more than six years and lives in Chicago with his wife and three children. He enjoys traveling with this family and snowboarding, and frequents ski resorts all over North America.