June 30, 2025

Estimating Forward-looking Returns in Public and Private Real Estate

By Michael Crook, Chief Investment Officer

Executive Summary

- Investors can access real estate exposure through publicly-traded REITs as well as private vehicles.
- Public REITs emphasize stabilized income, whereas value-add private real estate focuses on capital appreciation through operational improvements.
- Our research suggests that private value-add real estate presents attractive growth prospects, reflecting a premium for accepting illiquidity and execution risk, as compared to public REITs
- We believe public REITs and value-add real estate represent distinct exposures and should be viewed as complements—not substitutes—within a diversified real asset allocation.

We recently added value-add real estate to our target asset allocations. In discussions about the strategy, several investors have asked about publicly traded real estate – REITs (real estate investment trusts) – as a substitute for private real estate.

In this article, we provide a brief description of the types of investments found in public REITs and value-add real estate along with estimated returns for each strategy. It is our conclusion that public and value private real estate are complements, not substitutes, within a portfolio. In fact, we recommend target allocations to public REITs in our equity strategy, private REITs in our Alternative Income strategy, and now value-add real estate as part of a private investment strategy.

Public REITs and private value-add real estate

Public real estate investment trusts, or REITs[1], are companies that own income-producing real estate and trade on stock exchanges. REITs can invest in a wide range of real estate sectors, like office, residential, hospitality, healthcare, retail, and storage. REITs generally hold real estate that is *stabilized*, which means operating at normal occupancy and expense levels for the location and sector. In general, REITs try to offer predictable, recurring income for yield-focused investors.

Value-add strategies are usually found in closed-end investment vehicles in which the investor makes a commitment to the fund, capital is called as projects are identified, and then capital is returns as projects are sold within the fund. Like REITs, value-add private real estate can also invest in a similarly wide range of sectors, but is total return focused strategy instead of yield focused strategy. A value-add asset manager typically generates returns through forced appreciation, like renovations, reducing vacancies, elevating below-market rents, or making operational improvements, instead of collecting stabilized income.

Estimating REIT returns

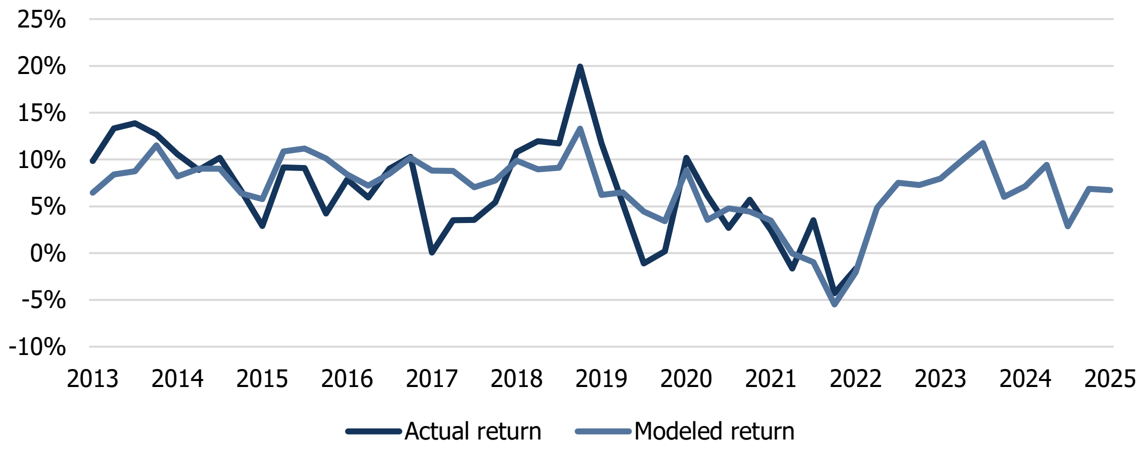
Absent the "animal spirits" that drive share prices above and below fundamentals, the total estimated return on a REIT is equal to the capitalization rate ("cap rate") plus the NOI growth rate. The cap rate represents the income yield received from the REIT at current market price and the NOI growth rate is the growth in Net Operating Income over the period in question.

We can create a decent model for REIT returns using cap rates and last-twelve-month NOI growth. The model (Fig. 1) currently estimates a 3-year annualized return on 6.7% for the NAREIT Index, which is a commonly cited index of REITs. REIT ETFs can be found for expense ratios as low as 0.08%.

Since REITs are traded on the stock market, the ever-present animal spirits in the stock market can push REIT returns above and below what fundamentals suggest. This phenomenon can be observed in the higher volatility of actual returns than what would be implied from estimated model-based returns. While there have been exceptions, it is rare to find extended periods where REITs perform well and stocks decline or vice versa (Fig.2).

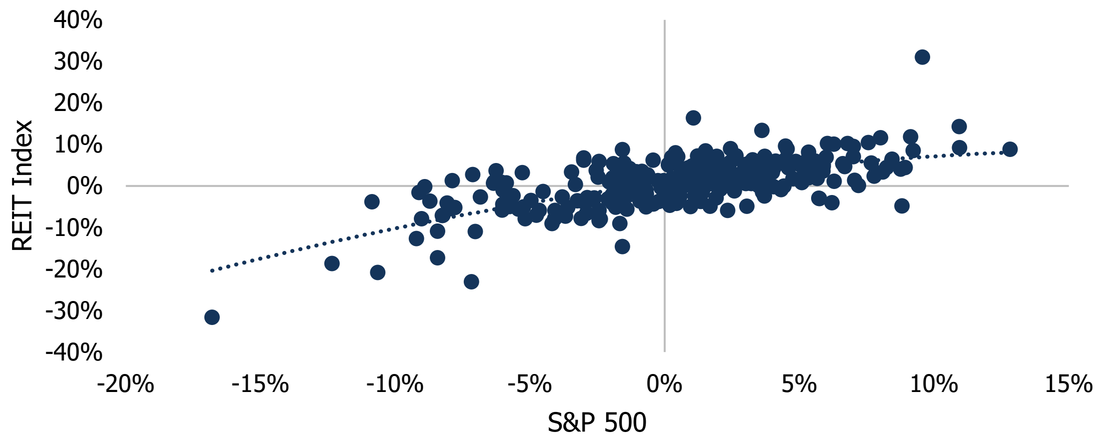
[1] For simplicity we have limited this paper to public REITs and private value-add real estate, but the full real estate opportunity set includes private REITs and limited partnership vehicles that invest in core, value-add, and opportunistic strategies.

Fig. 1: Modeled versus actual next-three-year REIT returns



Source: Bloomberg, Mill Creek. As of 03/31/2025. Based on quarterly data.

Fig. 2: Stocks and REITs tend to trade up and down together (3-year returns)



Source: Bloomberg, Mill Creek. As of 03/31/2025. Based on quarterly data.

Estimating private value-add returns

The nature of value-add real estate requires a different framework for estimating forward-looking returns since we need to include income and capital appreciation. A project-based return is generally used to account for the areas of appreciation mentioned earlier - renovations, reducing vacancies, elevating below-market rents, and making operational improvements. Asset managers also typically expect to sell – frequently to public REITs - at a lower cap rate than the asset was purchased for.

Every project in the private value-add space is unique, but a simple example might be a property that has an entry cap rate of 7%, NOI of 1.5mn, and a $23mn purchase price. If NOI is improved to $2.2mn over 3 years and the asset manager is able to exit at a 5.75% cap rate, the sale price would be expected to be $38.3mn, or a 16% project-level rate of return, based on the aforementioned variables.

Estimating forward-looking returns for value-add real estate, as a top-down strategy, is more challenging than for stabilized real estate as returns are more-highly predicated on idiosyncratic factors including the ability of the asset manager to improve the property and exit at a higher valuation. Investment due diligence can be significantly more complex than for stabilized real estate and must include the broader market environment along with a manager's ability to accurately underwrite projects, execute forced appreciation, and then exit the properties.

Investors should also be aware that fees are also usually higher than is typical for a public REIT and are more likely to include both a management and a performance fee that could erode 2-4% of the achieved gross return.

Our diligence of private value-add real estate strategies leads us to believe that they present an attractive opportunity as an addition to portfolios. This is evidenced by an April 2025 research report[2] from Newmark Research that found an average target net IRR of 16% for value-add and opportunistic private real estate funds.

Conclusion

From the standpoints of liquidity, transparency, and simplicity, Public REITs are a straight-forward way to gain exposure to commercial real estate and our public equity portfolios include REIT exposure. However, the forward-looking return profile for public REITs is commensurately lower than for value-add and REITs also tend to be correlated to the broader ups and downs of equity markets.

At the current time, we believe private value-add real estate offers a return advantage over public REITs, which compensates for the illiquidity and complexity that is a necessary aspect of investing in private value-add real estate through a closed end structure.

[2] Newmark Research, "State of the U.S. Capital Markets," 1Q25.

Disclosures & Important Information

MCCA is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Registration as an investment adviser does not imply a certain level of skill or training. This content is not intended to provide any legal, regulatory, accounting, tax or similar advice, and nothing should be construed as a recommendation by MCCA, its affiliates, or any third party, to acquire or dispose of any investment or security, or to engage in any investment strategy or transaction. An investment in any strategy involves risk and there is always the possibility of loss, including the loss of principal. This content should not be considered as an offer or solicitation to purchase or sell securities or other services.

Mill Creek Capital Advisors' (MCCA) Capital Market Assumptions that may be included herein are forward-looking risk, return, and covariance estimates for a range of broad asset classes. This information is not intended as a recommendation to invest in any particular asset class or as promise of future performance. They are created using a quantitative and qualitative process that incorporates current global economic and financial market conditions, market derived forecasts, and proprietary forecasts developed by the Mill Creek Investment Strategy Team. Our Capital Market Assumptions reflect our forward-looking views for one market cycle, which MCCA defines as including a bull and bear market. The duration of a market cycle has historically ranged from 2-15 years but are typically 5-10 years in length. Forward-looking return estimates are subject to uncertainty and error. Forward-looking returns for each asset class can be conditional on economic scenarios; in the event a particular scenario comes to pass, actual returns could be significantly higher or lower than forecasted. Because of the inherent limitations of capital market assumptions, potential investors should not rely exclusively on the assumptions when making an investment decision. The assumptions cannot account for the impact that economic, market, and other factors may have on the implementation and ongoing management of an actual investment portfolio. Unlike actual portfolio outcomes, the capital market assumption outcomes do not reflect actual trading, liquidity constraints, fees, expenses, taxes and other factors that could impact future returns. Asset allocation/diversification does not guarantee investment returns and does not eliminate the risk of loss. The broad asset classes are not representative of any MCCA investment asset allocation strategies and are used to represent general ranges of risk taking. Capital Market Assumptions are provided for informational purposes and as a tool for developing financial plans.

Forward-Looking Statements: Forward-looking statements involve risks and uncertainties, and there can be no assurance that the forward-looking statements that may be included in this commentary will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as representations or warranties of MCCA and that the forward-looking statements will be achieved in any specified time frame, if at all.

Index Returns: Index returns when included herein are provided for comparative purposes only. It is not possible to invest directly in an index. Index performance does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or transactions in fund shares. Such fees, expenses and commissions would reduce returns.