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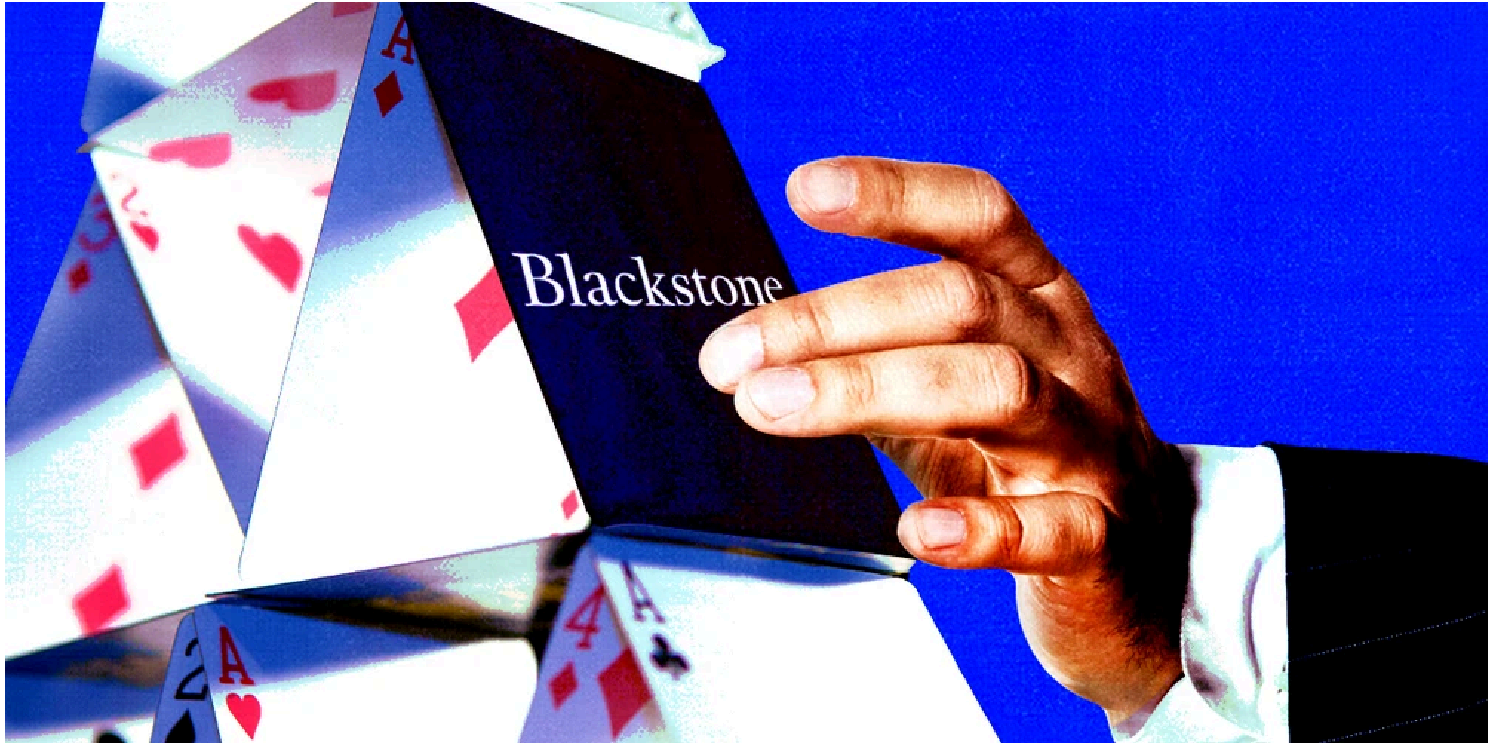
Blackstone's big gamble

Has the world's largest private-equity firm built a $114 billion house of cards?



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In 2017, Blackstone — the world's largest private-equity firm, which usually caters to big institutions and the very wealthy — decided to give ordinary investors an opportunity to get in on the firm's magic. It created BREIT, a private fund that buys commercial real estate like warehouses and apartment buildings, and marketed it to

everyday investors as an "all-weather strategy to build long-term wealth across market cycles."

And it *was* magic: By offering an annual dividend of about 4% in a world where interest rates were close to zero, BREIT quickly became a giant. At its peak in 2021, the fund was attracting as much as $3 billion a month in new investments. Today, BREIT boasts assets of $114 billion — about 8% of Blackstone's entire fee-earning assets — and has generated over $5 billion in management and performance fees.

But over the past two years, some investors have grown suspicious that BREIT isn't the rock-solid investment Blackstone claims it is. Since its inception, the fund says it has delivered an annualized net return of 10.5% — almost double an index of publicly traded REITs. Even as commercial real estate has been battered in the wake of the pandemic, BREIT has somehow managed to defy gravity, outperforming comparable funds by seemingly fantastic margins. In the fall of 2022, after the Fed's interest-rate increases began to shake the commercial real-estate market, investors began asking for their money back — more than $15 billion to date. Faced with a run on the fund, Blackstone cited a provision that allowed it to take its time refunding antsy investors — a decision that only served to further alarm the market. Shares in Blackstone tumbled by nearly 20%. Last year, BREIT failed to generate enough cash to cover its annual dividend.

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In recent months, the fund has appeared to recover from the debacle. BREIT announced it was able to fulfill 100% of the repurchase requests it received in February, which had slowed to just under $1 billion. Amid the promise of a rebound, Blackstone's stock has regained almost 50% from its lows. "I believe we'll look back at 2023 as the cyclical bottom for our firm," Steve Schwarzman, Blackstone's CEO, told analysts at an earnings call in January.

Investors in Blackstone's real-estate fund asked for their money back in droves — more than $15 billion to date. Jeenah Moon/Reuters

But the rosy picture that Blackstone paints may not tell the whole story. In recent months I've spoken with veteran analysts, accountants, and investors who have come to believe that BREIT is essentially a house of cards. That's because the returns the fund claims it has delivered depend almost entirely on BREIT's own estimates, which skeptics believe are wildly inflated. What's more, when BREIT faced a flood of redemption requests from investors, it only fulfilled all those requests after raising cash from new investors — including one that received a sweetheart deal from Blackstone to invest in BREIT. "It is the absolute definition of a Ponzi scheme," said Nate Koppikar, who runs a hedge fund called Orso Partners that has shorted

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Blackstone's stock because of concerns over BREIT. Unless the real-estate market comes roaring back, analysts warn, BREIT could end up shrinking to a fraction of its current size, leaving the fund's investors holding the bag.

"Surveying some of the ways that Blackstone has misled investors over the past five months, we are more convinced than ever that BREIT is a bad investment created for the benefit of Blackstone," Craig McCann, a financial analyst who served as an economist at the Securities Exchange Commission, wrote last year. "Investors should not accept anything Blackstone and BREIT state as truthful."

It's impossible to know exactly how valuable BREIT is. Because the fund is not publicly traded, the market doesn't set its price per share — Blackstone does. You buy shares in BREIT based on your faith in Blackstone's investing brilliance and in the firm's account of its own performance. Investing in a private real-estate trust like BREIT is, ultimately, an exercise in trust.

BREIT's returns are based on a measure called net asset value, or NAV. That's supposed to be the value of all the assets the fund owns, minus its debt. Blackstone told Business Insider that it has an "incredibly rigorous valuation process" — one it says has led it to adjust its NAV more aggressively than other REITS. But BREIT doesn't let investors or regulators see some of the crucial assumptions that go into calculating its NAV. As BREIT's financial documents state, Blackstone "is ultimately and solely responsible for the determination of our NAV." The methods used to calculate it are "not prescribed by rules of the SEC or any other regulatory agency," and the NAV "is not audited by our independent registered public accounting firm."

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Chilton Capital Management, which invests in publicly traded REITs, analyzed the way Blackstone adjusts the value of BREIT to reflect changes in the underlying real estate it owns. Rather than being "marked to market" every day — or every millisecond, like public REITS — Blackstone adjusts its NAV on a monthly basis. In today's volatile real-estate market, that means its stated value can lag way behind reality. "It inherently is a flawed process when prices are changing quickly," Chilton observes. "We refer to this imperfect appraisal process as 'mark to magic.'" In 2022, after the crash in commercial real estate, publicly traded REITs that own assets similar to BREIT's — multifamily housing and industrial buildings — have been selling at sharp discounts. But BREIT, by "marking to magic," has continued to claim far higher returns. Using a collection of market-based metrics, Chilton concluded last April that BREIT was overstating the value of its NAV by more than 55%.

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McCann, who is now a principal at SLCG Economics Consulting, reached a similar conclusion. He calculated that the cumulative returns of other funds in the sectors in which BREIT is concentrated plunged by over 30% in 2022. Yet BREIT claimed that its value *increased* during the same period. In the dry language of market analysts, McCann called the fund's claims about its NAV "unreliable."

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Blackstone considers such comparisons unfair. It insists that BREIT shouldn't be compared to publicly traded funds, which it argues are more volatile than private offerings. In a statement to BI, the firm insists that BREIT is able to outperform other funds for a simple reason: because it owns better assets than they do. BREIT's portfolio, Blackstone says, is "concentrated in the best performing sectors (data centers, logistics and student housing) and geographies (virtually no urban exposure)." Only 3% of BREIT's holdings are in office buildings, which have been ground zero for commercial real estate pain. The company points to its performance during the global financial crisis of 2008 as evidence of its ability to outperform its competitors during "periods of dislocation" and notes that it has sold $20 billion of real estate since the beginning of 2022, when interest rates began to rise, generating a profit of $4 billion.

"Not all real estate is created equal," BREIT boasted in a recent letter to stockholders, "and where you invest matters."

One of four commercial centers Blackstone owns near Lisbon. The company argues that BREIT's valuation remains high because the assets in its portfolio are superior to those in other funds. Horacio Villalobos/Getty Images

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But Blackstone's principal claim — that sounder investments have led to higher returns — is difficult to square with the ongoing decline of commercial real estate. It's hard to fathom how BREIT could have bought so many

properties at the height of the market and yet somehow been selective enough to have dodged all the post-pandemic downturns suffered by other funds. According to BREIT's own numbers, data centers and student housing make up only a small part of its portfolio. And many of the data centers Blackstone says have already created so much value for the fund aren't even up and running yet — they're still in development.

Publicly traded REITs, meanwhile, aren't the only ones marking down their assets. Bluerock Total Income + Real Estate, which has over $300 billion invested in a host of institutional real estate funds, has marked its NAV back to pre-pandemic levels — down more than 20% from its peak. Other major investors, unlike Blackstone, apparently don't see their real estate holdings as immune from the chaos buffeting the rest of the market.

Blackstone also argues in its marketing material that BREIT is better positioned than other real-estate funds because its balance sheet is "substantially hedged," meaning it has fixed-rate debt and derivatives in place that protect against rising interest rates. That's true — for the moment. But BREIT's future cash flows are, in fact, very sensitive to interest rates. At the end of last year, BREIT had $62 billion of debt secured by its properties, and it paid an effective interest rate of 4.3% that it locked in before rates spiked. But $47 billion of that debt will come due over the next four years — and if rates stay elevated, BREIT could face over $1 billion in added interest costs. That, BREIT has warned investors, "could reduce our cash flows and our ability to make distributions to you." Investing in BREIT is essentially a bet that interest rates are going to fall — because if they don't, it could be ruinous.

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You might argue that it ultimately doesn't matter if BREIT is overvaluing its NAV. As long as investors keep getting their hefty annual dividends, who cares? That's basically the same argument that Donald Trump made in defending himself against charges of systematically overstating his assets — that everybody made money, so no one was defrauded. But miscalculating the value of a vehicle like BREIT inflates the fees investors pay for participating in the fund while simultaneously depriving them of the opportunity to accurately assess the risk they're taking. In addition, Blackstone is incentivized to overvalue its NAV, because that's the number it uses to calculate the management and performance fees that investors pay. "It's a text-book example of conflict of interests," Robert Chang, the head of securities litigation at Fideres, a consulting firm that specializes in investigating corporate wrongdoing, wrote in a piece about BREIT. Fideres calculates that since early 2022, the fund's NAV per share has remained relatively stable — while public REITs have lost more than 30% of their value. If BREIT's assets are indeed overvalued, Fideres estimates, investors may have overpaid management and performance fees to the tune of hundreds of millions of dollars a year.

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The alarm bells over BREIT go beyond whether Blackstone is overstating the fund's value. BREIT has said that through June of last year, 100% of its dividends were funded by cash flows from operations — the

money produced by its real-estate assets. But that claim is more than a little misleading. In the measure of cash that BREIT highlights, it doesn't subtract the expenditures required to maintain its properties, which is standard for the industry. In its own fine print, in fact, BREIT does provide several other measures that are more analogous to how most REITS define cash flow; by those measures, the fund has never been able to cover its dividend from its cash flow.

> **No one I spoke with believes that Blackstone set out to build a house of cards. Rather, they say, BREIT was a victim of its own success.**

In its response to BI, Blackstone argues that because its management fees are not paid in cash, they are "properly excluded" from some of its measures. But not being able to pay the dividend you've promised can be seen as a Ponzi-ish warning, because it means the money has to come from selling off assets, borrowing money, or attracting new investors — a reality that BREIT acknowledges on the third page of its financial documents (and one that the SEC has noted as a risk factor for all private REITS). And if you subtract Blackstone's fees, BREIT has covered less than 50% of its dividend distribution since its inception. Indeed, one of the primary reasons BREIT has been able to pay its dividends is because roughly half of all shareholders have elected to receive their dividends not in cash, but in more shares of BREIT. In other words, the game depends on the continued belief of investors — on their willingness to accept shares of BREIT in lieu of cash.

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Getting paid in shares, of course, is not the same as getting paid in cash. The more shares BREIT issues to pay the dividend — and its fees to Blackstone — the less each share is worth. "On the surface, it all looks so safe," McCann tells

BI. "You're getting 4% or so a year, and you think it looks like a bond, and you think the underlying investments are doing well. Only when you dig in do you figure out that even if you're taking cash, the money is a return *of* capital, not a return *on* capital."

In 2022, when investors started asking for their money back in droves, BREIT faced a big problem. If its assets weren't marked correctly, it couldn't sell them off to pay investors without fessing up. Then the fund got what looked like a vote of confidence. In January 2023, BREIT announced that the University of California had decided to invest $4 billion in the fund, giving it a much-needed infusion of cash. Schwarzman called the investment a "validation" of BREIT's strategy.

But it wasn't. To entice the university to invest, Blackstone had offered it a special deal. BREIT agreed to award the university an additional $1 billion in stock in the event that the fund's rate of return fell below 11.25%. The deal was so sweet that UC's Board of Regents quickly agreed to invest another $500 million on the same terms.

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"Contrary to Blackstone's spin," wrote McCann, "the University of California investment strongly supports the view that BREIT is a terrible investment."

Students at the University of California protested the school system's investment in BREIT, which came after Blackstone offered a special guarantee on the deal. Michael Blackshire/Getty Images

Scoring the new investment helped BREIT pay off all those who wanted to exit the fund, albeit slowly. And for the moment, the stampede appears to have subsided.

Blackstone says that BREIT has "access to ample liquidity across multiple sources," including "$119.1 billion of high-quality real estate that can be sold at market prices if we choose to do so." But if investors stage another rush for the doors, BREIT could face a serious reckoning, especially given its high level of debt. If it has overvalued its properties, as some experts suggest, then it will have to sell its assets at a price below where they are marked. And the more shareholders it has to redeem, the faster its equity will become worthless. Those who get their money out early will be OK. Those who are last in line, not so much.

"If BREIT has to sell properties to meet redemptions, and they have to dip deeper into their portfolio to sell less desirable properties, they'll have to mark their NAV to reflect the actual sales prices," says Phil Bak, the founder and CEO of Armada Investors, a quantitative asset manager that specializes in REITs. "That could scare the people who have been clinging to fund performance as a reason not to redeem, which in turn causes a death spiral."

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No one I spoke with believes that Blackstone set out to build a house of cards. Rather, they say, BREIT was a victim of its own success. Money poured in at the height of the market, meaning that BREIT invested at a moment when commercial real estate was priced to perfection. Real estate, by its nature, is always somewhat illiquid — you can't sell your share of an apartment building on the stock market. And in a bad market, it's *very* illiquid, especially if what you own is marked at a price where no one will buy it. But while Blackstone says it designed BREIT so investors could get their money out, it seems not to have foreseen that scores of individual investors — unlike the big institutions that have typically been its clients, who are forced to commit their funds for long periods of time — might get spooked enough to ask for their money back all at the same time. Titans of Wall Street often believe that their brilliance should insulate them from skepticism. Their supreme confidence in their own wisdom is perhaps their most marketable asset.

It's completely possible, of course, that BREIT will survive, no matter how flawed its model might be. If the real-estate market reignites, that will boost the value of the assets in funds like BREIT. And if enough new investors are willing to place bets on BREIT — if trust in Blackstone's "magic" remains high — then everyone will keep making money, if only on paper, even if BREIT is overvaluing its assets. Blackstone's success has already created at least three billionaires, chief among them its CEO, Steve Schwarzman, who is worth almost $40 billion. The ability to enrich yourself seems to be a key part of what inspires others to follow your investment advice.

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CEO Stephen Schwarzman insists the worst is behind Blackstone, even as analysts remain worried about BREIT's prospects in a volatile market. Shannon Stapleton/Reuters

But there are plenty of warning signs that things could get worse. It's unlikely that the market will pick up fast enough to offset BREIT's woes. "Commercial real estate is a slow burn," Brian Moynihan, the CEO of Bank of America, recently observed. In its financial statements, Blackstone says it continues to count on "high single-digit growth" in its two biggest sectors, rental housing and industrial properties. But BREIT's overall growth was just 6% last year, and it has been decelerating quarter over quarter. If the market continues to fall, it will be harder for BREIT to claim it's the shining exception.

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To make matters worse, the way BREIT is structured could prove to be a ticking time bomb. Like other private vehicles, BREIT pays hefty commissions to financial advisors who steer their clients to the fund. All told, Blackstone has paid Wall Street banks and brokers more than $700 million in

brokerage fees. But for brokers who put their clients in BREIT early on, those commissions could soon hit a mandated cap of 8.75% — meaning they'll no longer be incentivized to sell the fund. If they start advising their clients to exit BREIT, it could spur an even bigger rush for the doors.

The future of BREIT could also send shock waves through Blackstone's bottom line. In 2022 alone, SLCG calculated, fees from BREIT generated 13.3% of Blackstone's total management fees and 12.6% of its performance revenue. If BREIT and its sister fund, BPP, are forced to slash their NAVs by 50%, the ensuing reduction in fees would wipe out over 15% of Blackstone's fee-related earnings — earnings that Wall Street, in contrast, is expecting will *grow* by 15%. According to Blackstone's financial statements, it's already anticipating it will have to pay the University of California $564 million in BREIT stock — an expense it doesn't count in the numbers it highlights to Wall Street. If BREIT craters, it will also be difficult for Blackstone to live up to Wall Street's expectations for its long-term earnings growth, which depend in part on its successful expansion into the retail market.

There are bigger issues at stake than Blackstone's bottom line. It's worth remembering, as Chilton notes, that private funds like BREIT were among "the biggest losers" during the global financial crisis of 2008. But that lesson seems lost on today's investors, who have once again flocked to private real-estate funds in a time of extreme market volatility. In the two years after the pandemic hit, private funds like BREIT raised $67 billion — far more than they drummed up in the two years leading up to the Great Recession. "While the tombstones may have different names on them," Chilton observes, "the reasons for the demise of private equity real estate players are going to rhyme, and possibly mirror those from the global financial crisis."

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That's why the story of BREIT involves more than profits and losses. It's only recently that private-equity firms like Blackstone have started offering products to ordinary investors. "BREIT was a test case for the whole industry," says Koppikar, of Orso Partners. Perhaps, given the questions swirling around BREIT, it's time to rethink whether the world's wealthiest funds should be trusted to take billions of dollars in fees from ordinary investors without more oversight. As it stands, it's impossible to know what BREIT's assets are actually worth — and therein lies the problem. In the absence of a market price, independent accounting and tighter government regulation are needed to ensure that investors have the accurate, verifiable numbers they need to make informed decisions. With private funds like BREIT, too much maneuvering takes place in the dark. And if history is any lesson, the dark is a very bad place to be doing business.

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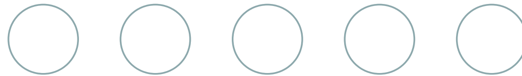

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