



PERE

UNDERSTANDING PRIVATE REAL ESTATE

An expert introduction to the fund and asset lifecycles

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THE QUEEN'S AWARDS
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Introduction

Welcome to PERE's specialist publication, *Understanding Private Real Estate*, which has been specifically tailored to inform and educate all practitioners, across all specialisms in all markets.

The publication is an invaluable reference companion for any professional – for those either working in private equity real estate or looking to move into this space – seeking an informed and insightful expert introduction to the fundamentals of investment management in this dynamic asset class.

Perhaps you're a new entrant to the real estate market or a junior-level practitioner. If so, *Understanding Private Real Estate* gives you a comprehensive practitioner's guide to the asset and fund lifecycles. The publication is designed to help you develop a clear understanding of the mechanics and processes involved at each key stage: raising a private real estate fund; sourcing capital from investors; learning how to value commercial real estate; successfully exiting an investment and winding down a fund.

For the more experienced private real estate professionals among you, the publication presents an excellent opportunity to refresh your understanding and benchmark your expertise, as well as broadening your overall knowledge to complement your field of expertise.

Each of the ten chapters which follow is authored by one or more leading practitioner in the private real estate industry. Each expert shares his or her insight and extensive knowledge of their area of specialism to bring each topic to life and to make it relevant to your overall understanding of private real estate.

In the first chapter, **Charles Conrath** of J.P. Morgan Asset Management and **Kasia Sielewicz** of DTZ co-author a comprehensive overview of the global private real estate asset class. They highlight the principal investment strategies employed by fund managers, typical fund structures and the key risks an investor in the asset class can expect to encounter. With an eye to the future, they also counter that deleveraging in the financial sector and a series of regulatory changes, such as the Alternative Investment Fund Managers Directive (AIFMD), are likely to alter the way that private real estate funds operate going forward.

Alan Patterson of AXA Real Estate Investment Managers examines real estate investing in the context of cyclical markets. His chapter also analyses investment trends and

drivers across regional markets – the US, Europe and Asia – in the office and retail spaces and considers the implications for investors. Patterson also discusses the outlook for 2012 and beyond and which investment strategy is most likely to appeal to investors and why.

In chapter three, **Lori Campana** of Monument Group presents a highly practical eight-step guide to sourcing capital for a private real estate fundraise. This covers developing and preparing the marketing plan, putting together an investor pitch through to the final investment stage. The chapter also identifies the key constituent parties likely to be involved in a fundraise and defines their specific roles.

Andrew Yoon and **Sonny Kalsi** of GreenOak Real Estate introduce in chapter four the different types of capital used by private funds to finance an investment in real estate assets. They also include a series of useful case study scenarios to illustrate the impact – both positive and negative – of different levels of leverage on cash flow and equity returns for investors.

Chapters five and six cover different aspects of real estate asset valuation. **Ollie Saunders** of Drivers Jonas Deloitte takes a detailed look at the role of the valuer and at the appraisal process used and methods employed to reach a judgement on the value of an asset.

In chapter six, **Phillip H. Gainey**, of the Royal Institution of Chartered Surveyors (RICS), goes on to discuss in more detail the three main approaches to valuing the real estate asset – the market, cost and income approaches. The chapter also sets out the sensitivity assumptions (such as refurbishment to assets, interest rates and lease terms) that can affect the value of an asset and must ultimately be factored into the real estate appraisal process.

Before deciding to commit capital to a fund, investors naturally want to find out as much information about the manager as possible, including how the manager's business is structured, past investments made and performance track record. **Hawkeye Partners** discusses these topics surrounding the due diligence process in chapter seven. This chapter also identifies some of the critical legal terms for investors when negotiating agreements with real estate fund managers.

For an insight into the asset management process, chapter eight, written by **Nigel Wheeler** of Jones Lang LaSalle, explains the role of the asset manager and the three key components of a successful asset management strategy – maximising income, minimising operating costs and risk management.

In chapter nine, **Deborah Lloyd** of the law firm Nabarro LLP examines the key issues and considerations at the final stage in the lifecycle of a private real estate fund – the dissolution process and exit strategy.

For a glimpse into the future of the private real estate industry, **Derek Williams** of Russell Investments reveals in chapter ten what he believes will be the top ten trends

and issues most likely to shape and influence the asset class and funds over the next decade to 2022.

Towards the back of the book you'll find a useful **Glossary** which is included to enable you to access quickly many of the financial and real estate-related terminology used in the chapters.

Finally, PERE wishes to extend its appreciation to all the authors for their time and effort contributing to this publication.

Helen Lewer

PERE

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Sourcing capital for a private real estate fundraise

By Lori Campana, Monument Group

This chapter:

- Describes the role of constituent parties, including investors, fund managers and placement agents, in the fundraising process.
- Addresses the choices involved in determining the best fundraising strategy for a private real estate fund in the marketplace in 2012.
- Presents an eight-step guide to sourcing capital from institutional investors.
- Sets out some guidelines for best-practice fund structuring.

Introduction

Signs of revitalised life have returned to the real estate investment marketplace in 2012. For the first time since the global financial crisis (GFC), prospective investors (limited partners or LP) are re-approaching the market and considering investing in private equity real estate funds after having either stopped or stepped back considerably from new investment activity. At the same time, general partners (GP) are coming to the table with new investment offerings.

Yet the fundraising environment has changed significantly from pre-crisis days. Collectively, investors are now more knowledgeable about alternative investments and have more experience with private real estate in particular. In the context of the recent GFC, investors are also likely to conduct more extensive due diligence prior to making an investment decision. This has resulted in highly demanding due diligence requirements both pre- and post-funding. Fierce competition for scarce capital has also emerged, on both supply and demand sides, as liquidity remains a challenge for all parties. Consequently, the fundraising market is both crowded and capital constrained.

Combined, these factors have made the need for careful planning of the entire fundraising process critical, from strategy to capital sourcing and fund structuring. In such an environment, successful fundraisings will be marked by meticulous preparation, expert execution and resolute persistence.

Roles of constituent parties

The constituent parties involved in the raising of a private equity real estate fund include the investors (LPs), the fund managers (GPs), placement agents, lawyers and tax advisers. All have important roles to play in the lifecycle of an investment fund. In each case, roles have evolved as the market has slowly emerged from the downturn that followed the GFC.

Investors

The LP universe is diverse and includes public and corporate pensions, family offices, endowments, foundations, funds of funds and sovereign wealth funds (SWF). When developing a fundraising strategy, it is important to be aware of the full range of potential investors available, including investors that may not previously have been on the radar screen. In the current environment, differences between investor types have also begun to emerge with some investors exhibiting more timely decision-making processes than others due to having had less exposure to the real estate asset class prior to the GFC and, therefore, may have more liquidity available to them for new allocations. As a result, GPs should consider the full range of investor types before placing any limits on their appeal to prospective investors.

General partners

GPs are the lynchpins of a real estate private equity fund. They not only direct the fund but also select, manage and dispose of the underlying investments strategically to generate a target return for its investors. As they draw up plans for new funds, GPs are finding that their fundraising role has changed measurably. A strong fundraise in 2012 is usually now preceded by a pre-marketing period lasting between three and six months. Very active engagement by all members of the senior team and many other professionals, both within the GP and its outside advisers, follows throughout the fundraise. In advance of a fundraise, GPs must be well prepared to respond to a standard set of due diligence requests and many individual requests as they move through the investment process with prospective LPs. Above all, GPs must be patient as the underwriting and approval process for an investor to make a commitment to a fund can be lengthy, often spanning six to twelve months.

Placement agents

Placement agents can play an important role in each step of the fundraising process, from advising on the planning and pre-marketing stage to consulting on best practices on how to communicate with LPs following a final close. Placement agencies come in all shapes and sizes from the sole operator model to the full-service investment bank operation. In between there are independent boutiques, including some that offer a full global reach.

The specific role of the placement agent depends on the agreement with the GP. A good agent will be highly knowledgeable about the GP's investment strategy and industry sector and a persuasive advocate of the merits of the opportunity without being pushy or hard-selling. Often, the agent must also play the role of facilitator, relaying sensitive information or assisting in negotiations between the GP and the prospective LP: diplomacy is, therefore, also an important trait.

Lawyers and tax advisers

Attorneys and tax advisers play a critical role in fundraising. In recent years their role has become even broader and begins at the strategy-setting point. Lawyers are involved in strategising about the fund structure and terms and in the drafting of the offering memorandum for funds. With the increased regulation of GPs and stricter regulatory requirements governing pension funds, compliance has become an area of renewed focus. Ensuring that fund strategies and structures comply with new rules

10

The future of private real estate: Predictions for the next decade

By Derek Williams, Russell Investments

This chapter identifies ten trends and issues that could impact the shape of the industry between 2012 and 2022:

- Secondary trading takes off on a global basis.
- Continuing domination of the US private real estate market.
- Long-term investors will include land as a core part of their real estate strategies.
- Evolution of the buy, hold and sell private equity fund model.
- An increased awareness of governance issues globally.
- The presence of new 'rising industry stars'.
- Core investment strategies will become a focus for investors.
- The shift from defined benefit (DB) to defined contribution (DC) pensions will present challenges and opportunities.
- The globalisation of real estate will increasingly require an industry body at the global level.
- Environmental, Social and Governance (ESG) issues will be top of the agenda for institutional investors.

Introduction

How is the real estate industry going to change over the next ten years? What will shape the industry over the longer term and beyond? Although to an extent this is moving into crystal ball gazing territory, there are indeed a good few trends that are afoot in 2012 that have clear potential to impact the industry in the decade ahead. Other trends are pure speculation and possibly seared with hopefulness. That said here are some boundaries for the thoughts presented over the following pages. First, the focus is on ten year trends – anything not expected to move the needle in that time frame has been discounted. Second, some changes are more localised and have a geographic focus. Some are global in nature. In either case, the geographic focus is identified. Third, the ten key trends are in no particular order.

Secondary trading takes off globally

In terms of investment in private real estate funds, primary transactions dominate over secondary transactions. According to JLL's Global Secondary Market 2011 Round-up report, there were \$5.5 billion in secondary trades in 2011, with 30 percent of that volume occurring in the UK.¹ Although there seems to be an upward trend of late, these figures suggest that secondary trading activity is not global and its market

¹ Jones Lang LaSalle, Global Secondary Market 2011 Round-up Report.

share as a proportion of the entire real estate market is negligible, measured in basis points rather than percentage points.

A few years' ago many pro-secondary groups cited the global financial crisis and overstretched real estate investors as an expected trigger to increase the volume of secondary trading activity. While certain specialist funds of funds have gained traction in capital raising, and there has been an uptick in secondary trades, the volume is still low and transparency is opaque. One market where transparency and liquidity has opened up is in the UK where there are many market players that regularly trade their UK fund exposure. However, secondary trades in the US, wider Europe and Asia are happening but are small scale in comparison to primary transactions. To put it into perspective, the opportunity fund currently being raised by Blackstone has closed on \$10 billion of commitments which is larger than the entire volume of secondary trades on a global basis in both 2010 and 2011.²

In a ten-year time horizon, there is likely to be considerably more interest in secondary trading, with better price transparency. It is difficult to predict a trigger event that will make that happen, but over the longer term the inbuilt demand from investors wanting to manage their exposures will mean that trading volume increases. Are there any obstacles to this happening? There are none that are insurmountable or unmanageable. The right of first refusal (ROFR) process – where existing investors effectively have a chance to buy out the ongoing investor – is one potential obstacle, but that does not apply to every fund and even when it does, it has proven to be a manageable process for the buyer, seller, GP and LPs alike. In an era of increasing customisation of real estate portfolios and globalisation, I can only see secondary trading making a difference in the long term which would ultimately benefit the entire industry.

US remains the dominant market

There has been a lot of commentary on the rise of other real estate markets like China, Brazil and India, and of course there is a power shift in terms of the economic balance between the US and other economies, which is opening up a realm of opportunities on a global basis. However, the country where the opportunity fund model started and which launched its first institutional real estate benchmark in 1982 (Frank Russell Company Property Index that is now called the NCREIF Property Index), and the geography that has the largest 'off-the-shelf' core funds in the world, is the US. This argument is not founded on whether the US economy will rebound and keep pace with other economies, nor is it based on the head start that the US had in terms of REITs and investing in real estate on a fiduciary basis. Rather it is based on a combination of the following traits that are likely to endure to the benefit of the US market:

- An attuned focus on alignment of interest.
- A distinct hatred of conflicts of interest.
- A strong and diverse consulting industry.
- Large players that are domestic and global, core through to opportunistic.

² Russell Investments (February 24, 2011), Efinancialnews, JLL Corporate Finance.