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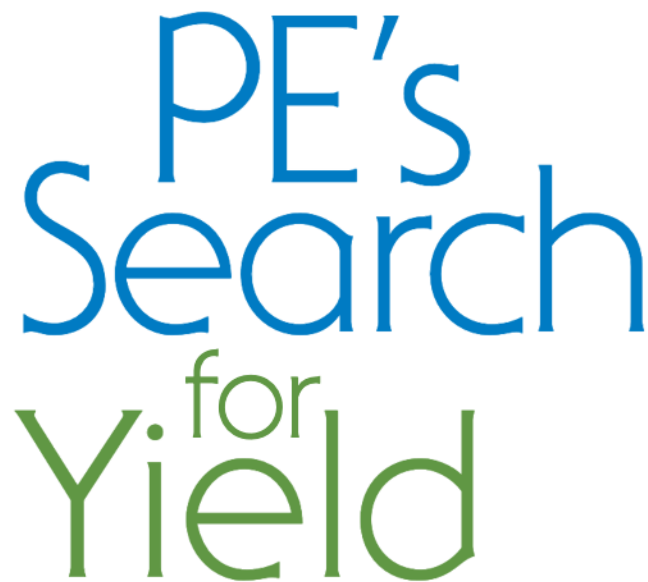


By Carrie Rossenfeld

The equity invested by closed-end private real estate funds in new opportunities in the US reached $67 billion in 2012—almost as much as was invested at the peak in 2007 of $68 billion, according to the latest Preqin report on the US private real estate fund-management industry. Clearly, private equity is interested in US real estate funds, but where is the smart money going to chase yield? REAL ESTATE FORUM explores the private-equity market, how it's investing capital and what the shrewd strategies are for achieving the best yield.

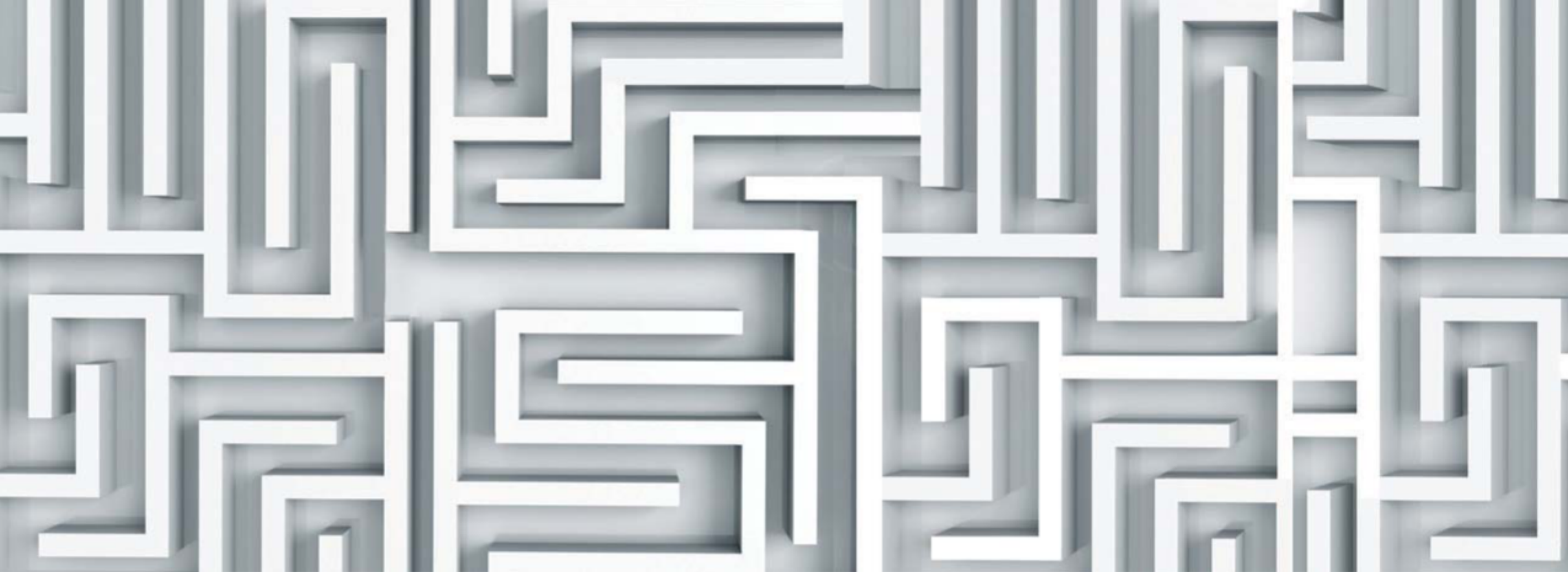
> CLEARLY, PRIVATE EQUITY IS INTERESTED IN US REAL ESTATE FUNDS, BUT WHERE IS THE SMART MONEY GOING?

With assets under management reaching an all-time high of $335 billion as of December 2012, according to Preqin's latest report on the subject, the private real estate industry has seen significant growth in recent years. And as the US real estate investment market becomes more crowded, PE is receiving strong interest from investors with higher risk tolerance seeking higher yield. The question is, where does PE capital go to achieve the yields for which investors are so thirsty?

Secondary Markets

Some say secondary markets are the answer. "If you go back a year or two or three, the money that was coming in from private equity—particularly foreign private equity, Canada and some other countries—was looking for class-A trophy buildings in prime cities like New York, Boston, L.A., DC or San Francisco," Jahn Brodwin, senior managing director in the real estate solutions practice at FTI Consulting, tells FORUM. "But, in New York City especially, the price levels we're seeing now are not what they were in 2007—they have surpassed them. While they had lots of capital to deploy, there were no deals that made any economic sense, so there was a bit of a stall in investment activity from a lot of these funds. Some of them chose not to buy, and others have decided to explore the secondary cities: Chicago, Miami, Houston, Dallas, Denver—cities in which, a couple years ago, they weren't that interested. In these secondary markets, they are finding high-quality assets they can buy with returns that make sense."

Indeed, the move toward secondary markets is one of the biggest recent changes for private equity, where the risk



"Management fees for fund managers are under pressure, while the costs of accounting and back-office operations continue to escalate."

SCOTT FARB
CohnReznick

tolerance is greater, but the payoff can be much higher than in the safer primary markets. "The smart plays right now are in secondary suburban markets, outside of the gateway cities where cap rates have gotten very compressed," says Pat Carroll, founder and CEO of the Carroll Organization. "We focus on multifamily value-add opportunities, and we've been active in specific submarkets around Houston, Dallas, Atlanta, Tampa and Orlando," while also looking closely at Phoenix and Denver. "We feel that these markets offer high-quality institutional-grade opportunities that can be financed similarly to core product, but the yields going in will be superior. Also, relatively speaking, there's not too much new supply coming on line in these markets, and good value-added investments have room for growth."

One concern about investing in the secondary markets is liquidity, another currently important factor for investors seeking high returns. "That's why they liked the trophy assets," says Brodwin. "There was a ready number of buyers if they wanted to exit. But in the secondary markets, it may take a little longer to sell."

Andrew Willis an SVP with Toronto-based Brookfield Asset Management, says access to capital has become increasingly important in PE investing since the financial crisis of 2008. "There are fewer funds today than there were five years ago, and access to liquidity is a competitive advantage."

Knowing going in that it may take longer to exit is one way for PE funds to avoid unrealistic expectations of liquidity in secondary market investment, Brodwin adds. "They will have to anticipate a little bit better. The plus is that they're buying into the lower price point at a higher cap rate."

Properties of lower quality with considerable upside potential in a variety of market classes are also being sought for yield, Brian Heller, a senior advisor with Sperry Van Ness in Los Angeles, tells Forum. Preqin's report, which backs this up, says most fund managers seek value-add and opportunistic investments for the greatest yield, although they come with the highest risk. Core and core-plus investments are less attractive since yields are generally lower.

"They want mismanaged properties with upside in rents, value-add opportunities to units and common areas with solid in-place cash flow," says Heller. "Properties that are the C to C+ property on a block, but located in B to B+ market areas with strong barriers to entry. Good employment and strong long-term market fundamentals are still at the core of every purchase."

Roads Less Traveled

Thinking outside the box is another option for greater yield. "In my view, alternatives, including student housing, medical office, senior housing and self-storage" are where the yield is, Al Rabil, managing partner of Kayne Anderson

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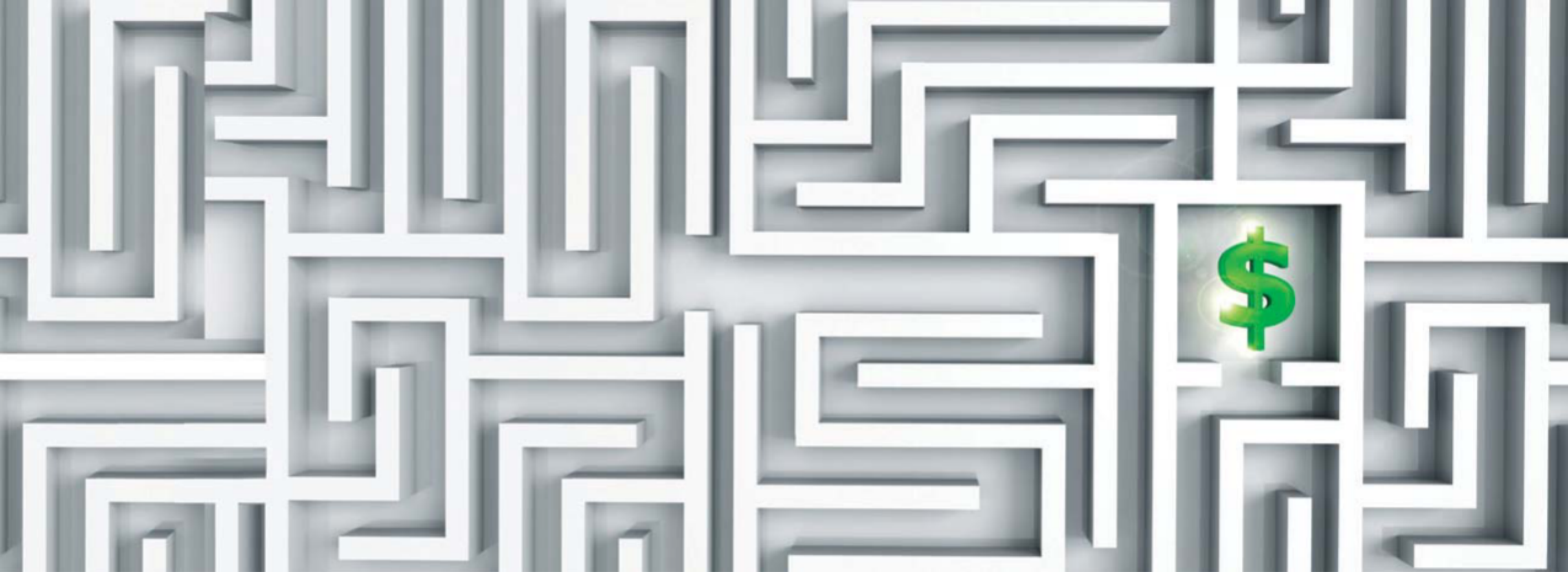

Capital Advisors' real estate private-equity activities, tells FORUM. "Specialized knowledge and operations give owners and investors a better chance to outperform, in my opinion, than core investments that are generally bought and sold based upon highest price."

Heller says that inventory is tight, especially for larger properties 30 units and above, which in turn is creating a lot of competition for these assets. He adds that his private-equity clients "prefer to avoid competition when possible, rather trying to cherry pick off market assets with upside in rents and value-add opportunities."

Scott Farb, a partner in CohnReznick's Los Angeles office, says that opportunistic real estate funds seek investments at the higher end of the risk spectrum such as development opportunities, repositioning properties, foreclosure deals, acquiring notes at a discount with the intention of acquiring the collateral property, or perhaps investing in markets or sectors that they believe are undervalued.

"For example, I'm working on over a dozen large-scale land-development projects around the country, for all of which the equity capital has been provided by larger institutional real estate funds," Farb says. "Another example would be the many real estate funds, notably Blackstone and Colony Capital, that have recently invested an estimated combined $9 billion in buying up single-family homes in bulk to rent out."

In fact, the US residential sector is a key area for institutional investors, the Preqin report finds, and Blackstone Group has raised the most capital of all private real estate funds in the past 10 years. (The firm was unable to comment to FORUM on the subject of PE strategies for this article.) Also, the most favored strategies of PE funds studied by Preqin are development, repositioning and redevelopment, which are utilized by 69%, 51% and 44% of fund managers, respectively.

Sunny Regions

Many PE funds want to invest in Southern California, says Heller, "for reasons including relative safety, potential rent appreciation, scarcity of developable land and historical appreciation, but the yield right now on most deals they are seeing is making it difficult to justify the prices." He adds that Texas (Dallas, Austin, San Antonio, Houston), Arizona, Colorado, Oregon, the Seattle area, North Carolina and, in general, the Sunbelt are the most talked about markets for chasing yield.

Heller adds that many of his clients regret not pulling the trigger on deals they saw in the past six to 12 months, since sale prices have risen so much, particularly in some of these sunnier markets. "Not only did deals have greater returns and upside than the ones we're seeing today, but the financing available was at better rates, too."

Changes, Challenges and Strategies

Preqin reports that the length of time that funds are taking to close has been on the rise, highlighting the continuing challenges that fund managers have in attracting investor capital in the current fundraising market. While closed-end private real estate funds focusing on the US have seen improved fundraising in recent years, current levels remain well below 2008, when 146 US-focused private real estate funds closed at an aggregate $71 billion.

With the changing economic climate, private-equity strategies have also changed. Smaller transactions in the private market seem to be on the rise, with most fund managers preferring transactions of under $25 million and an average property size of up to 500,000 square feet, according to Preqin. The majority of funds closed since January 2011 raised less than $300 million.

Expectations have changed as well. "A couple of years ago, everyone was swinging for the fences, looking for a home run in

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ANDREW WILLIS
Brookfield Asset Management

"There's plenty of capital for middle-market investment firms to raise on a deal basis, but none are willing to give you a blank check."

JAHN BRODWIN
FTI Consulting

three to five years," says Carroll. "Today, investors are more cash-flow oriented."

Heller says he believes "the drastic interest-rate hike we witnessed in the first week of July spooked a lot of smart money, causing them to pause for a moment while waiting to see if we reached an inflection point in the market. While buying seems to have picked up again since the initial shock, investors now appear more concerned with making sure they don't get trapped in five to seven years when they need to refinance and interest rates are higher. Thus, even if the numbers look good now, they have to be prepared for what the future holds."

Given the amount of money flowing into PE recently, Rabil says his firm has seen a big move toward consolidation and scale. While not a new theme, "it's a significant trend that I expect will continue for a number of years."

Rabil adds that large investors—pension funds, sovereign government entities, endowments, foundations, etc.—aim to consolidate their investments with a discrete number of firms and portfolio managers. "This leads to a dynamic of the 'haves' and the 'have nots' within the PE sector."

Willis notes a trend to developing greater operating expertise in private equity in order to generate value for clients. "We invest in quality businesses where operational improvement is the primary driver of value creation. In many instances, these businesses are experiencing temporary operational or financial challenges that impede results. In others, they offer a platform for growth with the addition of strategic advice and targeted capital."

In addition, PE funds are under unprecedented pressure with respect to increased transparency and investor reporting requirements,and an over-burdensome regulatory environment, says Farb. "Management fees for fund managers are under more pressure than ever, while the costs of maintaining accounting and back-office operations continue to escalate."

Also, the large PE funds have gotten substantially bigger recently, Brodwin says. "The Carlyles and Cerberuses of the world seem to have the ability to raise virtually unlimited amounts of capital. The smaller funds that are very highly specialized also thrive, and anyone not highly specialized or super large has found it difficult, if not impossible to raise capital on a programmatic basis. There's plenty of capital for the middle-market real estate investment companies to raise on a deal-by-deal basis, but none of them are willing to commit and give you a blank check."

Carroll says that his firm is also seeing a lot of demand from institutional partners for direct deals: separate accounts and co-investment structures instead of blind pools. "They're looking for more control and access to the deal, and a better understanding of our ongoing asset-management process. Along similar lines, institutional capital is aligning directly with experienced, high-quality operators. Overall, the trend is toward investors taking a somewhat more hands-on approach to real estate." ◆

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