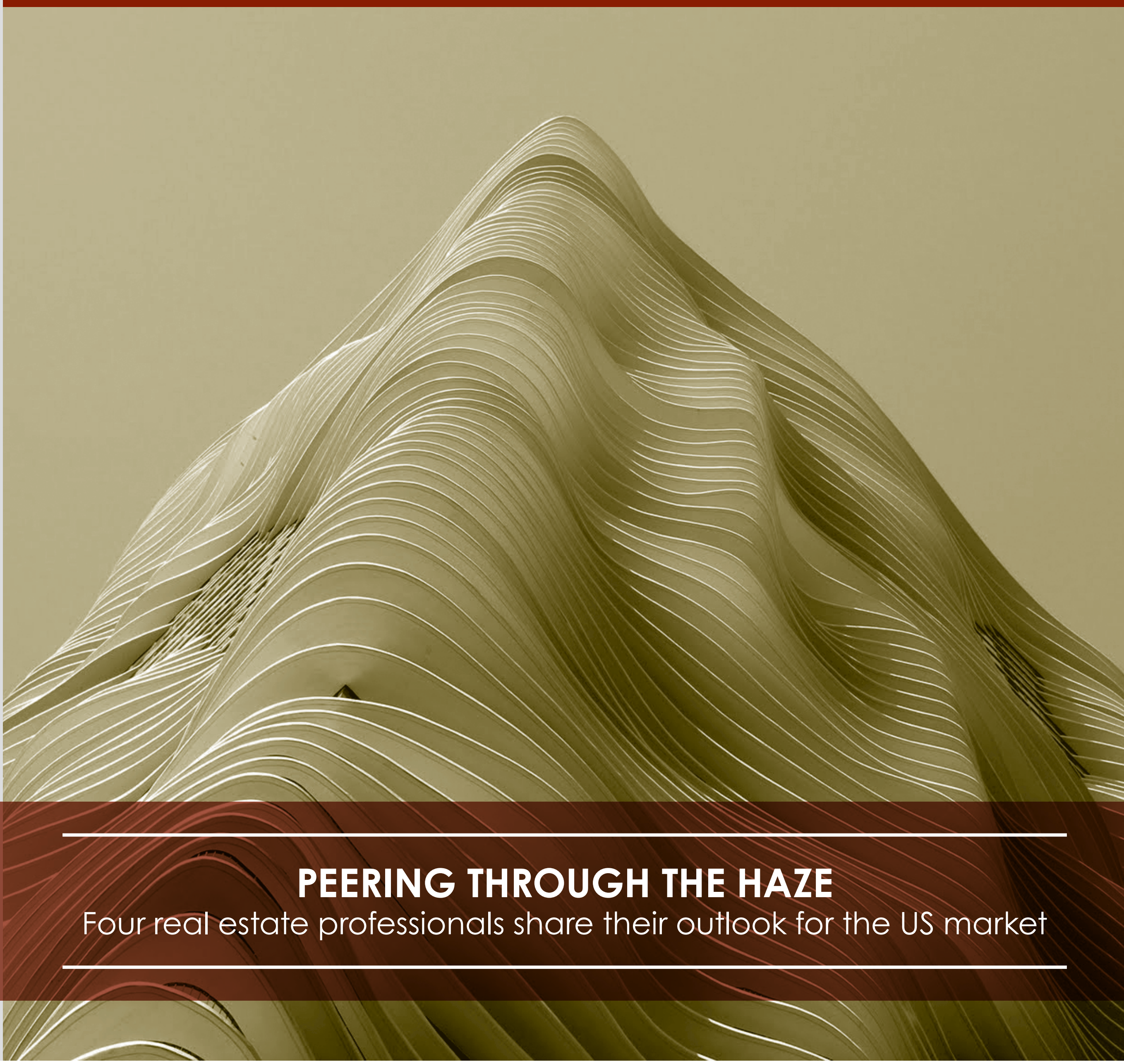
PEI Alternative Insight

PERE

VOL 8 | ISSUE 9 | NOV 2012 | perenews.com

FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS



PEERING THROUGH THE HAZE

Four real estate professionals share their outlook for the US market

Photography by Donald Bowers

(L to R) Charles Burd, Robert Insolia, Mark Grinis and Scott Brown

The land of clouded days

Commercial real estate in the US remains an attractive asset class in which to invest, even though its future prospects are less than clear.

By James Comtois

The US roundtable: still sees some dark clouds ahead despite the market's relative attractiveness

Commercial real estate in the US remains an attractive asset class in which to invest. Not only that, but the US is full of investment opportunities. However, that doesn't mean the investment landscape is paved with gold. In fact, it's quite the contrary.

The US landscape is filled with many traps and pitfalls: there are too many investors chasing after core properties; opportunistic assets are often mispriced; and there's too many managers chasing a limited amount of LP capital, which means many funds will close under their targets. In addition, there's increased confusion over various new and impending regulations such as the Jumpstart Our Business Startups (JOBS) Act, the Volcker rule and the Foreign Investment in Real Property Tax Act (FIRPTA), making reporting and obtaining offshore capital needlessly difficult in the eyes of some.

Still, because of good arbitrage, strong fundamentals and relative stability and profitability, many foreign and domestic GPs and LPs are looking to invest in US real estate. Fund managers and institutional investors also are beginning to see real estate as more of a long-term income play rather than just a short-term trade.

On a rain-drenched morning in late September, *PERE* met with four real estate professionals at Goodwin Procter's offices in the New York Times Building in midtown Manhattan to discuss such industry trends. Despite the atrocious weather, the view from the law firm's conference room was impressive. Equally impressive was their view of the current real estate investment environment in the US, despite some dark clouds on the horizon.

Scott Brown
Managing director
CBRE Global Investors

Brown is a managing director with CBRE Global Investor's global multi-manager business. Based in Boston, he is responsible for portfolio investment and relationship management in the Americas, as well as the group's investments in the US, Canada, Central America and South America.

Brown has more than 20 years of real estate experience. He formerly was the head of global real estate at Ennis Knupp + Associates (now Hewitt Ennis), a global multi-asset consulting firm, where he established the real estate practice and advised on $18 billion of investments in real estate. Prior to that, he was the senior department head for the private equity and real estate advisory business at State Street and a consulting manager at Kenneth Leventhal.

Allure of the US

Commercial real estate is still one of the more attractive asset classes in which to invest and, because of the instability in Europe and the economic slowdown in China, the US currently is one of the best places in which to invest in real estate. That is, as long as investors have reasonable pricing expectations.

Charles Burd, chief investment officer for the US at real estate investment advisor Bentall Kennedy, explains that it all depends on one's style of investing. For opportunistic investors, the US is a challenge because there aren't as many opportunities in the space as people once thought there would be. For core investors, good assets are still trading and there's a fair amount of capital in the space, although properties tend to be pricey.

Mark Grinis, partner at Ernst & Young, agrees. "When you think about where we are with respect to quantitative easing, interest rates and the economic outlook going forward, capital has to consider where to go," he says. "As a hedge against inflation, real estate still is generating good returns with superior fundamentals to many other asset classes." Within the US real estate market, he believes the single-family rental opportunity in particular "is going to be one of the top performers" over the next year or two.

Although the US real estate investing environment is attractive, Scott Brown, a managing director in the global multi-manager group at CBRE Global Investors, notes that investors in the US still like core and core-plus assets. However, the weight of capital for core could be the preference by default, particularly given heightened risk aversion globally. With a lot of instability in the rest of the world, the appeal of US real estate is relative in a multi-asset class portfolio, he adds.

"CBRE's target portfolio weighting is considerably overweight to the US currently. Economically, it's winning the contest of the 'uglies'," says Brown. "With somewhere between 1 percent and 2 percent GDP growth, it's a very bumpy road and there are a lot of opportunities to fall into the ditch."

Brown notes that CBRE also is seeing a lot of opportunity outside of the US, including a number of mispriced assets in northern Europe. In addition, the slowdown in China is creating opportunity in Asia, which normally has shorter business cycles.

"That said, the US is very attractive right now," Brown adds, "and recapitalisation strategies are probably the best way to access good pricing in the US."

Aversion to risk

Although many institutions want to invest in US real estate, the majority of them want to invest in core. With so many of these investors currently averse to risk, there appears to be a dichotomy between stable cash-flowing assets and secondary value-added properties. As a result, the US investment landscape is at a point where both vacancy and value-added is being mispriced.

Burd: real estate now filling its intended role

Despite this tendency to misprice vacancy in the US, vacancy isn't discounted as much in major markets such as New York and Boston. Burd actually sees the separation between major and secondary markets "driving the risk perception more than anything else."

Robert Insolia, managing partner at Goodwin Procter, adds: "The themes that we're seeing are that yield is king and there's an aversion to risk. It's not so much the particular asset class at this point."

Looking at inflows into core funds, where there's a queue of roughly $8 billion to $10 billion, it's clear that most investors are more interested in core these days. Part of the reason for the shift isn't just because LPs want to invest more in stable income-producing assets (although that's certainly the case), but also because investors are viewing real estate differently now than they did 10 years ago.

"They're now looking at real estate as what it should be viewed as: not a trading play, but as a long-term income play," says Burd, pointing out that a number of GPs and LPs are looking to build long-term core portfolios. "They're beginning to understand that the value in real estate does not come through a three- to five-year hold."

Despite the overall aversion to risk and opportunistic investing being a challenge in today's market, the current level of distress in the US is still high. Indeed, there currently are a large number of over-leveraged assets in the US, all of which require additional equity.

"The benefit of a low interest rate environment has provided lenders with time to execute orderly workouts, auctions and

Mark Grinis
Partner
Ernst & Young

Grinis is a partner in the real estate group at accounting and advisory firm Ernst & Young. He leads the transaction real estate practice for the Americas and heads up the firm's global real estate private equity practice. For more than 10 years, he has advised various ministries of finance and control banks for eight countries on strategies to address nonperforming assets.

Grinis has more than 27 years of experience, having been at the centre of distressed property markets in Texas in the 1980s, California in the 1990s and Asia throughout the Asian economic crisis. While in Asia, he was the managing partner for Ernst & Young's Asian real estate practice and advised such clients as the leading securities firm in the Japanese government and the largest city banks and insurance companies. He also served as lead advisor to the major investment banks in the underwriting and acquisition of real estate and nonperforming loans.

recaps," Grinis notes. "Yet, overleveraged properties also are suffering from borrowers living off the property's cash flow and not making adequate capital re-investment. This erosion of the collateral has deferred the distress, but ultimately it's only a deferral and these properties will continue to come to market in 2013."

Again, this is because there's so much capital from funds looking to be put into deals. The Townsend Group recently reported the amount is somewhere in the vicinity of $82 billion.

"That's the big difference between now and 1991 and 1992," says Insolia, "when there wasn't even $1 billion to go out as equity."

Indeed, there is a great deal of capital in the market that wasn't available 20 years ago. Brown and Burd point out that there currently is quite a bit of non-US capital—and not just institutional capital—finding its way into the US. The problem, however, is that there just aren't enough quality deals in which to invest said capital. As a result, a great deal of capital is just sitting on the bench.

Fundraising challenges

As Townsend recently reported, there are more real estate funds in the market than there have ever been before. Ironically, LPs are paring back their investment budgets and committing to fewer funds in the US these days. As a result, there are too many funds in the market chasing capital and many of these commingled vehicles are going to close under their targets, if at all.

"It's very difficult to raise a new fund if you don't have a track record," says Grinis. "For those that don't have a long track record but do have a pipeline that can be validated, there are investors willing to back select new entrants to the market."

Robert Insolia
Managing partner
Goodwin Procter

Insolia, a managing partner at the law firm of Goodwin Procter, represents and advises clients involved in the capitalisation of real estate through public and private capital markets. In his current role, he has assisted clients with the formation of domestic and international private equity and real estate funds, REIT IPOs and follow-on public offerings, the formation and capitalization of investment managers and finance companies, mergers and acquisitions of real estate operating companies and the purchase, sale, financing and restructuring of real estate and real estate-related assets.

Insolia currently serves on Goodwin Procter's executive committee and as chair of its management and allocations committees. In 1997, he was a founding partner of the firm's New York office, which he chaired through 2004. He also chaired the business law department of the New York office through 2007 and was co-chair of the firm's real estate private investment fund practice.

Brown: investors are seeking more control

Wheelock Street Capital is an example of one of those new entrants to the market that managed to succeed through a strong deal pipeline. Although the Greenwich, Connecticut-based real estate investment firm had no track record, its founders did, which helped the firm raise its first fund. Since Wheelock's founders had great track records and could show a pipeline of deals they had done since the firm's inception in 2008, the firm went to market with its first fund in 2011 and managed to raise a substantial amount of capital from some large LPs.

Wheelock, however, is more of an exception rather than the rule. "Of the 85 or so real estate investment managers we represent, historically if they needed capital for deals, they would've gone out and raised a blind-pool fund," says Insolia. "That's extremely difficult now. The adage of working twice as long and twice as hard for half as much is an understatement."

With many of the top players like The Blackstone Group, Starwood Capital Group and Westbrook Partners still able to raise significant amounts of capital and many small, first-time managers benefitting from emerging manager programmes from players like the Teacher Retirement System of Texas, it appears that the middle of the manager pool is really the area that's getting squeezed. Because of this, many fund managers are beginning to drop out of the fundraising game ahead of schedule, closing earlier than planned on lesser amounts.

"On one hand, real estate continues to be an attractive asset class, the US is a very attractive and the inflows are going to increase through 2013. On the other hand, institutional investors are reducing the number of managers they invest with," Insolia explains. "You can find niche players who are succeeding in capitalising themselves, but we're inevitably going to see a reduction in the number of real estate investment managers in the fund space over the next couple of years."

Another challenge GPs are facing from LPs is that, in addition to them scaling back their allocation budgets, LPs are also pushing down their costs, squeezing fees and demanding more control. In fact, some LPs want more control over things like extensions past the end of the term. Others want to be direct investors but aren't set up to do so, so they go into funds and try to control such investment decisions as approving major leases.

"One item that we focus as an LP investor is the option to control our exit timing," says Brown. "An aspect that gets our attention when reviewing new investment opportunities is higher proportions of pre-specified assets in a vehicle with like-minded investors that do not need too much discretionary control in the governance."

Although these LPs should invest through a separate account or programmatic joint venture, Insolia points out that, for various reasons, they often do not. "A general partner has to be very careful to make sure that, in the fervour to get a deal done, it doesn't agree to terms it can't ultimately live with," he warns.

Rules and (self-) regulation

When asked how the various regulatory initiatives in the US – the Dodd-Frank Act, the Volcker Rule and the JOBS Act – have affected the private equity real estate space, none of the executives had anything positive to say. Brown notes that the bulk of these additional regulations are only causing increased uncertainty among GPs and LPs and potentially choking off capital that could otherwise enter the US investment markets.

"The US has to take a hard look at whether FIRPTA is really creating an even playing field or if it just is stopping the massive flows of investment capital from coming into the US and creating jobs," says Brown. "Personally, I think it's the latter."

Insolia points out that, with the current regulations that have been imposed, it doesn't appear as if any systemic risks have been taken out of the system. Instead, he believes that the new regulations have put a lot of very costly bureaucratic requirements on fund managers.

For example, the most significant regulation that's been put in place in the real estate industry has been to require real estate investment managers to be registered investment advisors. However, Bernie Madoff was a registered investment advisor, and that didn't do anything to prevent his Ponzi scheme.

"I question whether requiring this industry to be registered investment advisors is going to really change or reduce the risks that the investors face," Insolia adds.

Although the executives agree that the industry needs some regulation, they also note that the market has been self-correcting on its own as LPs continue to impose greater diligence and oversight. The industry is significantly more sophisticated these days and, in many ways, institutional investors are policing GPs. Unsophisticated investors may get taken advantage of, but it appears as though most major LPs investing in real estate via fund managers have large, sophisticated staffs scrutinising and analysing each potential deal.

Brown further notes that most investors also hire tax advisors and lawyers to help them make these investments. Therefore, the due diligence going into these transactions on the part of the institutional investors, not necessarily the new governmental regulations, is what's mitigating risk in these deals.

So again, although the industry definitely could benefit from regulation, it doesn't appear—from the four real estate professionals' viewpoints, at least—that the government is necessarily benefiting the investment environment when it comes to delivering effective regulatory initiatives.

"With numerous regulations and more on the way, the government's response is more like 'Ready, Fire, Aim'," quips Grinis.

Charles Burd
Chief investment officer
Bentall Kennedy

Burd is the chief investment officer for the US at Bentall Kennedy, where he is responsible for creating investment strategy and policy and overseeing the firm's US separate account business. In addition, he oversees the development of new products, ideas and platforms and serves on Bentall Kennedy's US executive and investment committees.

Burd has more than 30 years of experience in real estate investment management and pension advisory services. Prior to joining Bentall Kennedy in 2009, he was head of separate accounts for Morgan Stanley Real Estate Investing, where he was responsible for the oversight of $8.5 billion in assets and direct management of several major separate account relationships. Prior to Morgan Stanley, he held senior positions at several real estate advisory firms, including Bristol Group and AEW Capital Management.

Insolia: systemic risks have not been addressed by regulation

Futures and options

Despite the fact that the US is still an attractive place in which to invest, there are many storm clouds on the horizon. So, with too many funds in the market, a lot of capital sitting on the bench and government regulations potentially limiting offshore capital coming into the US, what are the options for real estate investors for the future?

According to Burd, development is still an option for private equity real estate. "One of our main drivers is build-to-core strategies," he says, citing Hines' plans to develop a 470,000-square-foot trophy office tower across from Bryant Park in Manhattan as a prime example of where development is still alive and well in the sector.

Grinis agrees that development is still a key focus for many in the industry. "We surveyed a significant number of large fund managers, and they said the top three investment strategies in the coming year were equity re-caps, bank portfolios and development opportunities."

"You have to be careful in the deals you're doing," Burd adds, agreeing that there's still a demand for development among the smaller niche strategies. "We've stayed very urban focused."

Grinis: development is a key focus for the industry

7 Bryant Park in Manhattan: a prime example of the build-to-core strategy

Despite such deals as Hines' Bryant Park tower, there are relatively few office developments going on, even in some very supply-constrained markets like New York. Brown says that, for CBRE, the only development that it has its eye on in the US is multifamily development in supply-constrained markets. The US investment strategies in which Brown currently sees value are de-risked property portfolios with sound fundamentals via secondary LP interests, asset or vehicle recapitalisations, or club deals and joint ventures in pre-specified portfolios. He also sees value in demographically demand-driven niche property segments, such as student and senior housing or healthcare-related offices.

Meanwhile, Bentall Kennedy plans to continue to grow its core and open-ended funds. "We'll also export some of our build-to-core expertise in Canada, where we are vertically integrated, to bring more of that to the US," says Burd. In addition, the firm plans to expand its separate account business and again focus primarily on its build-to-core strategies.

Recently, the California Public Employees' Retirement System (CalPERS) bought Ivanhoe Cambridge's ownership stake in Bentall Kennedy, making it a one-third owner in the firm. But, according to Burd, this shouldn't change the firm's plans moving forward.

"CalPERS replaced an existing platform investor. Since CalPERS was an existing client, it's not a new relationship for us," Burd explains. "We wanted a like-minded owner. The fact that it is a US investor is good because it supports our North American investment platform."

For Goodwin Procter, Insolia says: "Our goal in 2013 is to help our clients capitalise their investment activities, manoeuvre them towards the capital in this continually evolving landscape and get them to a place where they can do the deals on an attractive basis."

Insolia adds: "On a relative basis, I think it's going to be a good year." □