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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS



SPECIAL OPS

The PERE US Roundtable examines the rise of the operating partner



A photograph of three men in business suits standing in front of a large window. The man on the left is wearing a grey suit and a red tie. The man in the middle is wearing a dark suit and a dark tie. The man on the right is wearing a dark suit, a red tie, and glasses. They are all standing with their hands clasped in front of them. The background shows a city skyline with a prominent skyscraper.

Calling all operators

With the flood of foreign capital coming into the US real estate market, operators are in demand like never before.

By Evelyn Lee

(L to R) Jason Kern of LaSalle Investment Management, John Ferguson of Goodwin Procter, Ambrish Baisiwala of Portman Holding, Gerry Casimir of TIAA-CREF, Eric Bergwall of Allianz Real Estate and Eric Wurtzebach of Macquarie Capital

For foreigners, the United States has long been known as ‘the land of opportunity’. But when it comes to the US real estate market today, opportunities haven’t been so easy for overseas investors to find.

Just ask Eric Bergwall, the interim chief executive and head of portfolio management for Allianz Real Estate of America. “We acknowledge the competitive environment, so we need to be smart and patient as we grow,” he says.

His comment confirms that Allianz will have exhibit some patience itself because so far the real estate investment arm of the German insurer currently has invested about \$8.5 billion in US real estate, with \$7.5 billion in debt and \$1 billion in equity, but it hopes to grow both books, such as expanding its US real estate debt portfolio from \$7.5 billion to \$12 billion over the next three years.

Echoing him during the *PERE* US Roundtable on the 26th-floor conference room of The New York Times Building in New York City, was John Ferguson. The co-chair of the real estate private investment funds practice at law firm Goodwin Procter, adds: “The real scarcity is not the capital, it’s the opportunities.”

Indeed, “the amount of foreign capital currently looking to invest in the US has never been greater,” says Eric Wurtzebach, managing director in the North American real estate group of Macquarie Capital, the capital markets, corporate advisory and principal investing arm of Macquarie Group. “The flood of capital is only increasing, especially from Asia.”

Much of that capital hasn’t even arrived yet, he adds. An example is Chinese insurers, which had over \$1.2 trillion of total assets at the end of 2012, and are just starting to actively invest in real estate on a global basis. Meanwhile, Macquarie estimates that these insurance companies have a target of 1.2 percent allocation to overseas real estate, which translated to approximately \$14.4 billion of liquidity in 2012 that was to go into overseas, and primarily US, real estate, says Wurtzebach.

“There have always been significant capital flows” into US real estate, says Gerry Casimir, head of global real estate asset management at TIAA-CREF. But “the capital flows have increased that much more.” The New York-based financial services organization, whose clients include sovereign wealth funds such as Norges Bank Investment Management and Future Fund, had a \$4 billion pipeline of business in the US last year, but that increased significantly in 2014, he notes.

Rise of the operator

The opportunities to find outsized yields without taking on significant risks have largely dried up. “One of our challenges is to compete against the abundant buckets of capital,

both foreign and domestic, that are active in the market today - not only investment managers, but also direct institutional investors, public REITs, non-traded REITs,” says Jason Kern, chief executive officer of the Americas at LaSalle Investment Management. “This kind of market puts even more onus on the investment manager than ever to source those increasingly hard-to-find, off-market, under the radar screen deals.”

The competition for core assets has become so fierce that many institutions are now paying core pricing for what traditionally have been value-add opportunities. “In the absence of anticipated further cap rate compression, everybody is chasing NOI growth,” says Kern. “There are many buyers now that are paying up for vacancy, so as a seller, you’re able to realize fully stabilized value, even when there’s some work to be done on the asset. In a way, you can attract more capital in some cases than just a fully-leased stable asset, because people will buy the dream.”

Casimir notes that the spreads between core and value-add have narrowed, particularly in the gateway markets. “I think one of the big differences is between price and value,” he says. “Many sellers are now underwriting significant value growth in the current sale price of an asset. There’s a difference between price and value.” A building has to have 50 percent vacancy rather than 30 percent vacancy to be considered “value-add” in today’s market, he notes.

Given this backdrop, institutions have had to search for alternative ways of achieving yield. Cue in the operator.

Just take a look at the largest-ever private real estate development in the US, Hudson Yards. The project, which ultimately will encompass more than 17 million square feet of commercial and residential space in Manhattan, is a joint venture between Oxford Properties, the real estate investment arm of the Canadian pension plan, Ontario Municipal



Ambrish Baisiwala
Chief executive officer
Portman Holdings

Baisiwala is in charge of the overall operations of Portman Holdings, including real estate development, investment and capital raising across the US, China, India and

South Korea. Based in Atlanta, he has been with the firm since 2006. Before joining Portman, Baisiwala was development director of ALDAR Properties PJSC in Abu Dhabi, UAE, where he oversaw a development portfolio of more than \$30 billion.



Eric Bergwall
US head of portfolio
management
Allianz Real Estate of America

Bergwall oversees of Allianz Real Estate of America's \$7.1 billion debt and \$1.2 billion equity portfolios and is co-chair of the firm's debt investment committee. As head of portfolio management, he is involved with portfolio strategy, investment strategy, asset management, risk management, reporting and servicing in the US. Based in New York, Bergwall joined Allianz as a managing director in March 2011 and was appointed interim CEO in September 2013.

Employees' Retirement System, and Related Companies.

Another operator that has formed a major partnership with a foreign institution is Forest City Enterprises – which incidentally is building another massive New York City development, Pacific Park Brooklyn, a 22-acre residential and commercial real estate project in Brooklyn that was formerly known as Atlantic Yards. Last year, Queensland Investment Corporation Global Real Estate, the real estate arm of the Queensland, Australia government-owned investment firm, made its first direct US real estate investment by forming a joint venture with Forest City to invest in a \$2 billion portfolio of eight malls.

Partnering with operators began to gain popularity in mid-2000s, as global investors began to seek more input and control over their property transactions. The global financial crisis then intensified global pensions and sovereign investors' desire for control and alignment after they were stuck in commingled funds with smaller LPs that had liquidity and allocation issues as property values decreased.

In today's yield-starved environment, control is correlated with better-performing investments. In exchange for providing hundreds of million in equity, the global investor will exercise more control over the governance, structure and financial terms of the partnership than compared to traditional commingled funds. "Investors are using that pricing power to get better returns from groups that have controlled assets or have that in a pipeline already – they are disintermediating capital aggregators," Wurtzebach says.

Moreover, institutions not only are investing with operators, but in some cases even are investing in those operators. "This year, we've seen an increased appetite for entity-level investments in private operators, simultaneously coupled

with LP investments at the real estate level," he says. With such investments, the investor is buying into the operating platform in order to better access pipeline transactions and ensure manager alignment.

Of course, just as the competition for US real estate assets has been heating up, so has the competition to partner with best-in-class operators, which in addition to more control, offer investors greater alignment. "That's causing sovereigns and global pensions to focus on quickly identifying those best-in-class operators to try and lock up relationships," says Wurtzebach.

And although many institutional investors are seeking to team with specialist operators with national platforms, such firms are in limited supply. "There aren't a lot of really good, national private companies that don't have an existing commingled funds business," he says.

More develop-to-core

Most of these partnerships with operators are focused on creating core assets. "That's what we hear from investors," says Wurtzebach. "How do you create core assets instead of buying these assets at today's pricing?"

Indeed, Macquarie's investment banking activity has focused on develop-to-core transactions, having executed nine such deals raising over \$3.2 billion of equity over the past three years. Most of those transactions have been structured as club deals between two sovereign wealth funds or global pension funds and one real estate operator – a complex arrangement that many investors had not often considered in earlier years. "That's one of the things that's changed, the crush of capital has investors looking at structures and asset classes that they hadn't prior," says Wurtzebach.



Gerald Casimir
Head of global real estate
asset management
TIAA-CREF

Casimir is responsible for the overall strategy, performance and day-to-day activities of TIAA-CREF's global real estate investments,

excluding Europe. He joined the organization in 2002 and previously led domestic acquisitions for the north region and value-add property acquisitions. Based in New York, Casimir joined TIAA-CREF in 2002. A 27-year real estate veteran, he previously held positions with Eastdil Realty Advisors, and Schroder Real Estate Advisors.

Develop-to-core is a relatively new concept, involving an investor taking on initial development risk in order to own a stable core asset in the long term at a better basis than if they bought at today's cap rates. Prior to this model, outside of primarily REITs, development in the US had mostly been merchant build, where a developer and equity partner focus on IRR and sell the asset quickly upon completion and stabilization. With develop-to-core, however, the investor wants to hold the asset long term and benefit from the higher cash flow that comes with the lower development basis.

Meanwhile, the develop-to-core concept also has resonated with operators in the aftermath of the global financial crisis. "They want to stabilize their platform," says Wurtzebach. "They just went through a very difficult time when they had to fire staff and their equity partners disappeared." Hence the shift by operators into establishing relationships with institutional investors and building asset management platforms in order to lower risk through cycles and generate revenue by holding assets long-term.

"The operators are saying, 'I see continued good growth ahead and it's hard to get these assets so why do I want the merchant banking mentality of selling?'" he says. "I can get my development promote in the interim and also hold long term and have the best of both worlds."

The concept of develop-to-core investments reflects another shift in the US real estate market: the desire to develop assets for long-term hold instead of selling upon stabilization, notes Casimir. "Today most investment strategies are based on long-term investments, no matter who you talk to. I think that's a fundamental change."

Underwriting risk

Develop-to-core transactions, however, can be notoriously



Jason Kern
Chief executive officer, Americas
LaSalle Investment
Management

Kern oversees the firm's business activities and staff in the region, and also serves on the firm's global management commit-

tee and North American private equity investment and allocation committees. Before joining LaSalle last year, he worked at the Hong Kong and Shanghai Banking Corporation (HSBC), where he founded and led HSBC's Asia-Pacific real estate and lodging advisory group. He is based in LaSalle's Chicago headquarters.

difficult to underwrite. "I think no one has cracked the code yet as to how to produce a product that has both development and core within the same vehicle, because the risk return profile from the development phase is obviously different than the hold phase in the life of a property," says Ferguson. "From the investment management perspective, the appropriate performance expectations, and correspondingly the compensation to the manager, for each of those two segments is different."

The main challenge is determining compensation for development risk. "That's the question: are you getting as an investor compensated for that additional risk?" says Kern. Getting an additional 100 or 150 basis points by developing rather than buying might be a reasonable return on risk depending on the property type, such as an industrial development that has already been permitted. "But in other property types, people are taking on quite a bit of risk without getting paid for it."

The wrinkle is that the developer invariably takes on more risk that the capital provider, because the latter typically doesn't come into projects until they're shovel-ready. "Under my scenario, the money can't afford to take that risk," says Bergwall. "Your IRR will deteriorate rapidly if you're taking permitting risk. So I need to come in when the permits are ready, but the developer has taken that 18 months of risk already, how do they get compensated?" Moreover, Allianz doesn't like to lever deals because of the increased risk involved. "Can I find a partner who's willing to do it that way, and how do I make the math work for them?"

The promote can be "a sticking point" in structuring these types of investments, Casimir adds. "The issue is what amount of promote is appropriate to award the operating



John Ferguson
Partner
Goodwin Procter

Ferguson is co-chair of the real estate investment funds practice, chair of its infrastructure practice and partner in the business law

department of Goodwin Procter. He represents a wide range of clients in forming private investment funds, partnerships, joint ventures and other transaction structures, as well as acquisition, financing, restructuring and disposition transactions. Based in New York, he started at the firm in 1998 and was named partner in 2005.

partner for value created, particularly without the occurrence of a liquidity event. However, it may be worth giving up some of the yield to the operating partner if there's enough downside protection," he says.

Ferguson, who also is chair of Goodwin Procter's infrastructure practice, suggests that more real estate deals might consider mirroring the terms of one client's infrastructure fund. While the fund, which had a 25-year life, had a traditional private equity-style waterfall, the waterfall went away in the 12th year of the fund, upon which time the manager crystallized a promote in-kind.

Allianz was in a similar scenario in a recent development deal where a promote was crystallized approximately six years into the partnership. "There's risk obviously, how do you monetize that?" says Bergwall. "Is it equity in kind or is it a cash check? It's not ideal, but it helps to bridge that gap." He adds that he's been in talks with residential developers that want to diversify their business into investment management. These merchant builders are less concerned about a promote because they are more interested in building a platform and having a fee business.

No-fault divorce

Another potential point of contention is the investor's rights in the venture, particularly in the event of a breakup. Wurtzebach notes that many institutional investors are demanding certain rights that are non-negotiable: "One of the things that sovereigns and global pensions insist on today is a no fault divorce. No fault divorce is standard today with these deals and expected. You didn't see that in the last cycle, and that is the way it is today. You very rarely can get it any other way."

Ferguson, however, argues that the level of control that the



Eric Wurtzebach
Managing director
Macquarie Capital

Wurtzebach is a managing director in the North American real estate investment bank arm of Macquarie Capital. Based in New York,

he is part of a global real estate advisory team that has raised more than \$49 billion in equity commitments for a range of private real estate transactions over the past 11 years. Before joining Macquarie in 2008, Wurtzebach was a director of investment banking at BMO Capital Markets; a founding partner of Silver Portal Capital.

No niche sectors

With so much competition in the US real estate market, staying ahead of the curve has become an increasingly lofty feat. "There's no niche sectors left," says Kern. "If you go down the list – student housing, healthcare... there's so much capital chasing each of those sectors."

Medical office, for example, used to be a niche sector where an investor could get a sizable spread against suburban office. "No more, there is no spread," he says. LaSalle still likes medical offices, however, because of the fundamentals and stickiness of the tenants and the demographics relating to the aging Baby Boomers and the Affordable Healthcare Act. "So we'll take medical office over suburban office all day long, but you're not getting a significant yield premium per se," adds Kern.

Bergwall also likes the medical office strategy, but says one hurdle is the size of the investments that Allianz has to make, since the German insurer can generally only invest in transactions that are more than \$100 million. Such a constraint limits the property types where Allianz can invest. "I think that's true of a lot of the sovereigns – I don't see Norges investing in medical office," he says.

Wurtzebach, however, points out that US property types such as multifamily, student housing and storage don't exist in many other countries. Meanwhile, the majority of new capital entering the US is targeting the office space. "Many foreign investors are targeting office because of their familiarity with the asset class in their home market and the need to deploy capital into larger deals. On a relative basis, I think there are better pricing opportunities in niches, because there's just not as much of a familiarity with those asset classes today, and they're not as big in terms of deal size."

capital provider has in a partnership isn't always so clear-cut. "The 90 percent partner may control the board and have all these great governance rights, but they're sort of veto-type rights, reactive type rights, they're not affirmative rights," he says. "So depending on how those deals get structured, the investor may not have adequate control rights during a downturn."

Ambrish Baisiwal, CEO of Atlanta-based real estate developer Portman Holdings, moreover, questions the wisdom of a limited partner removing the operator. "The question is once they take it over, where will they go?" he asks. "Because they'll still have to find somebody else. And if

you have operating or construction loans in place, as well as completion guarantees, and the operator has provided these, the banks will have to approve the transaction.”

Indeed, Wurtzebach has yet to see an investor exercise a no-fault divorce clause. “It’s a stick to bring to the table to get everybody talking,” he says. “The last thing investors actually want to do is pull this trigger.”

Beyond development

Other partnerships between institutional capital and an operator are less development-focused. For Casimir, one potential opportunity is investing with retail operating partners that own top-tier malls. Many such operators are remerchandising their retail mix to drive sales and retail rents and therefore are looking for capital. “If you look at the mall space, at least the dominant fortress malls, they’ve outperformed every asset class, so investing in the dominant

centers with strong operating partners makes sense,” he says.

Meanwhile, big recapitalizations have emerged as a growing trend, where investors in large existing portfolios don’t want their capital back and instead wish to roll over the assets and extend the hold period. In fact, TIAA-CREF and Allianz formed such a joint venture in 2012, when TIAA-CREF sold a 49 percent stake in the Four Oaks office complex in Houston to Allianz, which invested more than \$200 million in the transaction.

“That’s the ideal model for us, and that’s the ideal model for most foreign institutions, to find a well-heeled partner like that and buy into an existing deal they have, and hopefully that augurs additional investment,” says Bergwall.

Many foreign institutions are taking a long-term view of the US real estate market. Clearly, one way they plan to stay for the long haul is through the partnerships they forge in the market. □

Operating funds

With an increasing number of operators now managing third-party capital, raising commingled funds has become a logical step for many of these firms. “Even in the fund world, there continues to be a shift toward operators,” says Wurtzebach. “Many well-known commingled fund managers have lost significant AUM, disappearing off the top lists, and firms with true operator/developer expertise are increasing their market share. I think it’s an interesting development.”

However, not all operators favor the fund model as a means of raising and investing capital. Ferguson said that some operator clients that have had the ability to raise funds ultimately opted not to do so. “They thought they could get better economics just by doing deal by deal JVs,” he says. “And they didn’t like the idea of a waterfall where the performance of all deals were aggregated. Those are obviously folks who have no trouble raising capital in the first place, because they have an active pipeline.”

Baisiwal agrees. “As an operator, I’ve never been convinced that’s the best way for us to raise capital, because the notion of going big with a certain deployment period just forces us to put the money out or give it back,” he says. “That’s not really good for our business.” He adds that having a specific deployment period isn’t optimal for Portman Holdings. “It takes time to put these deals together, so it’s almost artificial in a way, so I’m not convinced as an operator that that’s a good model for us.”

Similarly, some institutional investors overall prefer non-fund structures, whether or not they’re investing with an operator. “They want to be closer to the real estate, and they want to get the money out more on a real-time basis,” says Ferguson. That said, even the largest institutions still may have a need for commingled funds.

Ferguson notes that a silver lining for the real estate fund industry is the tax structuring requirements for non-US capital that is looking to set up a separate account. However, the foreign institution typically wants or needs to team up with one or more investors to get its stake in the venture below 50 percent, and then also find matching US capital for the non-US capital.

“There remains a place for the commingled fund, because I think the separate account, as hard and expensive as they are for lots of investors, can be doubly challenging for many non-US investors because of the US tax considerations,” he says.

Meanwhile, “we have actually started to see some sovereigns and global pensions reconsidering funds because they have so much capital to deploy and they can’t deploy it fast enough through operating partners,” says Wurtzebach. “They’ve got to get capital out, and they’ve got pressure.”

Bergwall agrees. “We struggle to get the money put out that way because of the kind of competition and the deal flow. We are looking at some funds today that we weren’t looking at two years ago,” he says.