



# The Challenges Facing Investors in Private Real Estate

Drawing on data from [Preqin Investor Network](#) and the [2013 Preqin Investor Network Global Alternatives Report](#), [Andrew Moylan](#) examines the challenges investors face when looking to construct private real estate fund portfolios.

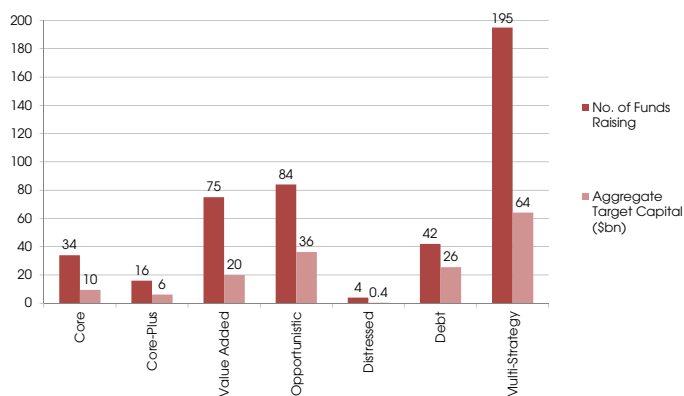
Although investors in private real estate funds are more sophisticated than ever and are conducting even greater levels of due diligence on potential real estate fund commitments, it remains extremely difficult for institutions to identify the best opportunities. In this article we examine the challenges investors face with fund selection using data from [Preqin Investor Network](#) and the [2013 Preqin Investor Network Global Alternatives Report](#) (click [here](#) to download your complimentary copy), as well as why investors continue to be attracted to investing in private real estate.

## Opportunities

The private real estate fundraising market remains extremely crowded, with 450 closed-end private real estate funds in market targeting aggregate commitments of \$162bn (Fig. 1). There are a diverse array of funds offering investors exposure to a wide range of strategies, property sectors and risk profiles. As shown in Fig. 2, a significant proportion of funds in market incorporate a combination of at least two strategies. As a result, it can be difficult for investors to identify the funds that will help them best meet their desired portfolio composition and offer the potential to generate strong risk-adjusted returns.

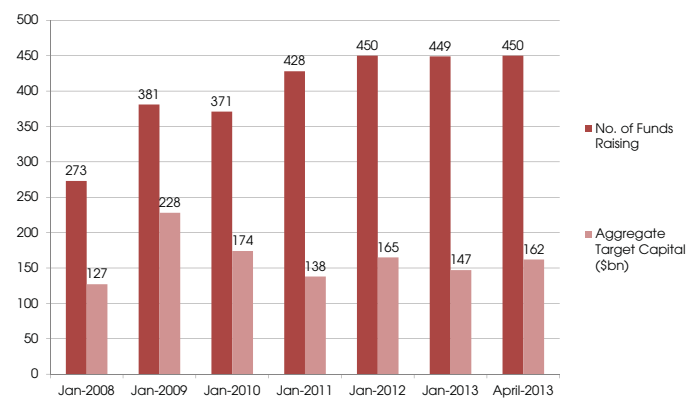
Another concern for institutions investing in real estate is that the competitive nature of the fundraising market means that not only are there a wide range of funds vying for investor capital, but also in many cases managers may not be able to successfully raise the funds they are marketing. Investors may be forced to make a judgement not just on the attractiveness of a fund as an investment opportunity, but also on whether the manager will be able to raise sufficient capital for a fund to be viable. One hundred

Fig. 2: Closed-End Private Real Estate Funds in Market by Strategy



Source: Preqin Investor Network

Fig. 1: Closed-End Private Real Estate Funds in Market, January 2008 - April 2013



Source: Preqin Investor Network

and fifteen closed-end private real estate funds were abandoned between January 2012 and May 2013 and, of the funds in market that have yet to hold an initial close, 45% have already been on the road for more than a year. It seems likely that many managers of these funds will not be able to successfully close these offerings.

Identifying top performing fund managers is one of the biggest challenges for institutional investors and their consultants. As shown in Fig. 3, there is significant variation between the performance of top quartile and bottom quartile funds, with this being particularly notable for the worst performing vintage years. Top quartile closed-end private real estate funds have never returned negative IRRs in any of the vintage years displayed in

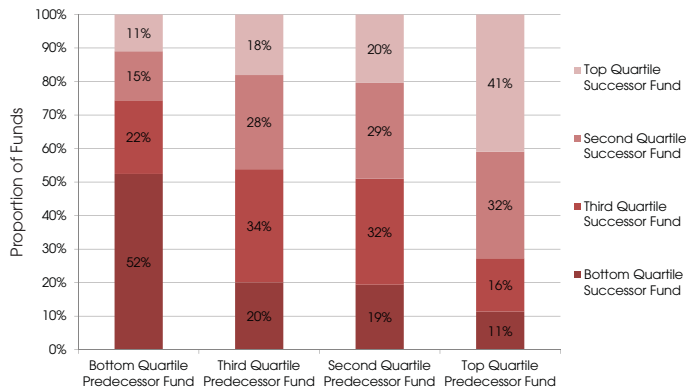
Fig. 3: Closed-End Private Real Estate Funds - Median Net IRR and Quartile Boundaries by Vintage Year



Source: Preqin Investor Network

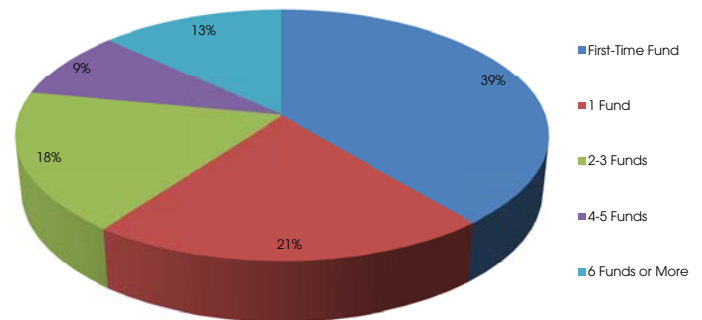


Fig. 4: Closed-End Private Real Estate Funds - Relationship between Predecessor and Successor Fund Quartiles



Source: Preqin Investor Network

Fig. 5: Breakdown of Private Real Estate Firms Managing Closed-End Funds in Market by Number of Funds Raised



Source: Preqin Investor Network

Fig. 3, but more than half of 2005 and 2006 vintage funds are generating negative IRRs. For 2006 vintage funds there is an 18.4 percentage point difference between the top and bottom quartile boundaries.

Although a manager's track record is not a guarantee of future performance, past performance can provide a good indication of future performance to investors. It can also demonstrate in particular how managers navigated the more turbulent market

conditions in 2009 and 2008, an important consideration for many investors in private real estate. As Fig. 4 shows, 73% of managers of a top quartile fund will go on to surpass the median fund return with their subsequent offering, with 41% again ranked as top quartile. To aid investors in identifying strong performers, Preqin Investor Network allows investors to see the full performance track record for all managers with a real estate fund in market.

## 6,000 Reasons to Contribute Data to Preqin

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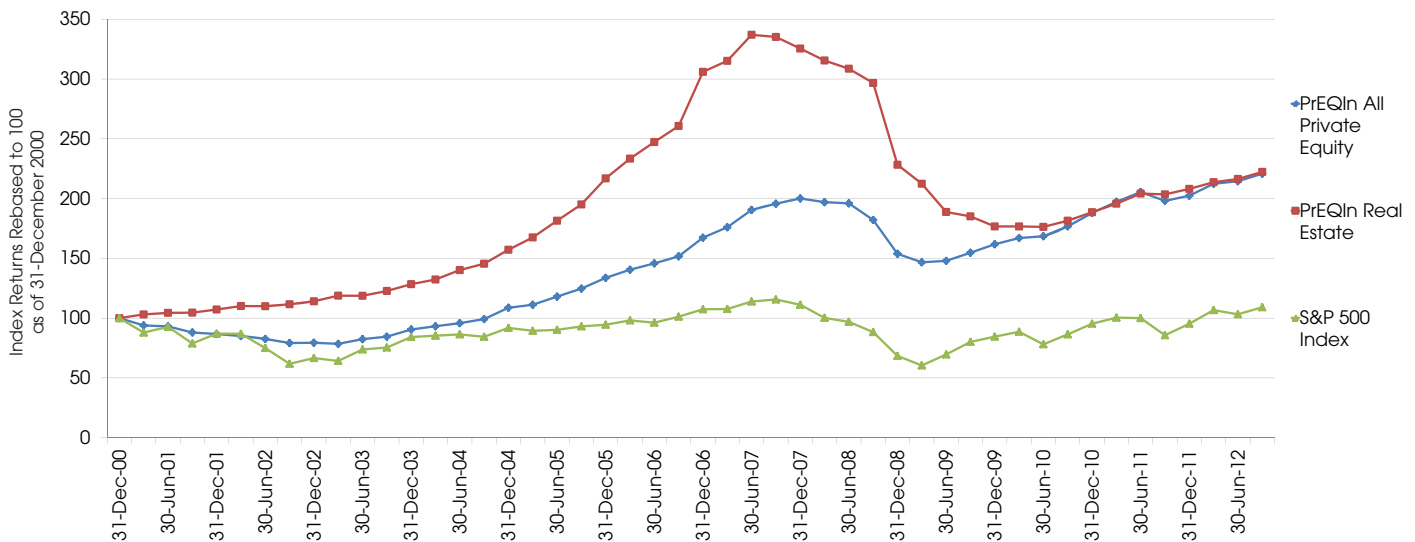
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Fig. 6: PrEQIn Quarterly Index: Real Estate vs. All Private Equity and S&amp;P 500



Source: Preqin Investor Network

However, a large proportion of funds currently seeking investor capital are being raised by relatively inexperienced firms. As shown in Fig. 5, 39% of managers raising new funds are seeking capital for their first offering, while a further 21% have closed just one fund previously. New managers can often prove to be strong performers, and of the first-time funds of 2000-2010 vintage years, 35% are ranked as top quartile, with only 19% ranked as bottom quartile.

Savvy investors, with the knowledge and resources required to conduct due diligence on first-time funds, may look to identify the best prospects among the next generation of fund managers, but with so many new managers attempting to raise capital, this is a difficult task. For many others, the additional due diligence required and the additional risk associated with investing in first-time funds means this is a route they are unlikely to consider.

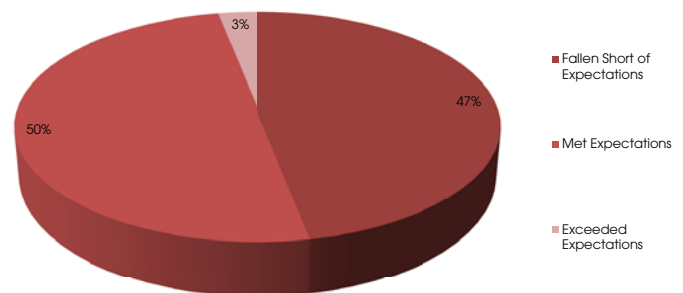
### The Role of Private Real Estate

Real estate remains attractive to many investors for several reasons. Real estate portfolios can offer diversification, act as an inflation hedge, and provide a steady income stream. Most investors, however, will still expect real estate, and in particular private equity real estate funds, to offer strong performance compared with traditional investments. The financial and liquidity costs associated with getting access to private equity real estate funds mean that returns above and beyond other asset classes are required to justify investors' commitments.

The PrEQIn – Private Equity Quarterly Index – captures in an index the returns earned by investors on average in their private equity and private equity real estate portfolios based on the actual amount of money invested in these partnerships.

Fig. 6 shows that, over the long term, private real estate has outperformed the S&P 500 index. Despite encouraging performance in recent quarters, the PrEQIn Real Estate Index, rebased to 100 as of December 2000, remains well below its June 2007 peak of 337.0, having fallen significantly in 2008 and 2009. As of September 2012, it stood at 222.8, narrowly above

Fig. 7: Proportion of Investors That Feel Their Private Real Estate Fund Investments Have Lived up to Expectations



Source: Preqin Investor Outlook: Real Estate, H1 2013

the PrEQIn All Private Equity Index, which stood at 220.8, and well above the S&P 500 index which stood at 109.1.

While the All Private Equity Index has returned to the levels seen before the downturn, the Real Estate Index has not seen this level of recovery. Many investors suffered significant declines in their portfolios, and so it is perhaps unsurprising that 47% of real estate investors interviewed by Preqin in December 2012 believe the performance of their private real estate portfolios fell short of their expectations (Fig. 7). For investors planning new commitments, however, the performance of more recent vintages does offer some encouragement, with the median IRR for 2009 and 2010 vintages currently 15.3% and 13.4% respectively.

### Outlook

The vast majority of institutional investors with an allocation to real estate remain committed to the asset class, with 52% expecting to maintain their allocation in the longer term and 39% planning to increase it. However, navigating the private real estate fund market remains difficult for investors. With a large number of



managers vying for investor capital, and an increasingly diverse array of fund offerings, fund selection is very challenging.

[Preqin Investor Network](#), a free service for accredited investors and qualified purchasers, draws on Preqin's fundraising, performance and fund terms data in order to help accredited investors navigate the range of opportunities available in the private real estate

market. Subscribers to the platform have full access to profiles of every private real estate fund currently seeking investor capital, including details of the fund strategy, investment preferences and any interim closes held. It also includes information on the history and track record of fund managers with a vehicle in market, plus fund terms benchmarks and net-to-LP fund performance.

#### Data Source:

[Preqin Investor Network](#) is a free tool for accredited investors looking to source new investment opportunities, providing information that can help with asset allocation, fund selection and due diligence. Accredited investors can access:

- Full information for 450 private real estate funds currently in market, including geographic, property sector and strategy focus, and fund manager contact details.
- Benchmark returns for private real estate funds by geographic focus and strategy, and the PrEQIn Real Estate Index.
- Performance track records of any fund managers with a fund currently seeking investor capital.
- A fund terms calculator, allowing investors to compare benchmark terms for funds of different sizes, strategies and geographic foci.

For more information, or to register for free access to [Preqin Investor Network](#), please visit:

[www.preqin.com/pin](http://www.preqin.com/pin)

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- ▶ **Receive** an unbiased, quantitative assessment of a manager's track record in a standardized and easily analyzable format.
- ▶ **Spend** less time on administration and quantitative analysis, and more time making critical decisions with the right information.

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