2015 Preqin Global Real Estate Report

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The 2015 Preqin Global Real Estate Report Contents

Private Real Estate in 2015 – A Competitive Landscape

- Andrew Moylan, Preqin

Private Equity Real Estate Assets Growing

The private equity real estate asset class saw further growth in 2014, with assets under management reaching an all-time high of $742bn. One of the key drivers of this growth is increases in real estate valuations, which have led to significant rises in the value of portfolios held by fund managers. Private real estate funds saw an average increase in net asset value for 17 straight quarters to June 2014. Naturally, this has led to improvements in performance, with real estate funds generating annualized returns of 16.7% over the past three years and 93% of institutional investors feeling fund performance has met or exceeded expectations.

Another driver of the growth in assets under management is the increasing levels of dry powder. Uncalled capital stood at $217bn as of December 2014, having increased by over $30bn over the course of 2014. With such large amounts of capital available to fund managers, and more interest in real estate from a range of other players, most notably the largest sovereign wealth funds, competition to put this capital to work is now intense. Pricing for prime assets is a concern for many in the industry, and 75% of fund managers feel there is more competition for core real estate than a year ago, but there is also a similar picture when targeting value added or opportunistic deals, with a similar proportion seeing an increase in competition. Aggressive pricing and a competitive landscape is making it harder for managers to source transactions, with two-thirds of fund managers Preqin surveyed in November 2014 saying it is harder to find attractive investment opportunities than 12 months ago.

While some industry players may have concerns about whether there is enough product for all this capital to be invested in, fund managers largely believe now is still a good time to invest. More than two-thirds expect to invest more capital in 2015 than they did last year.

Fundraising Steady

The rate of fundraising in 2014 remained broadly in line with that seen in 2013, with the $91bn secured by funds holding final closes in 2014 representing a small decline on the $92bn raised the previous year. Several of the biggest names in the industry raised large offerings, with Blackstone Group closing the largest ever solely Europe-focused fund, the €6.6bn Blackstone Real Estate Partners Europe IV, while Lone Star Funds, PIMCO and Kildare Partners all closed sizeable funds in 2014. The fundraising market is only becoming more competitive, however; there were just 182 funds closed in 2014, 59 fewer than in 2013 and 79 fewer than 2012, with capital increasingly concentrated among the largest players.

This means the fundraising market is becoming ever more competitive. Seventy-two percent of fund managers said they have seen an increase in competition for investor capital compared to 12 months ago, not surprising given how many managers are vying for institutional allocations. There are now 450 funds being marketed, almost two and a half times the number of funds closed in 2014. Those managers that did successfully close funds spent an average of a year and a half on the road, and 41% fell short of their fundraising goals. Some 61% of fund managers seeking commitments have already been marketing their offerings for more than a year, and it is clear that not all will be successful. Fundraising continues to be particularly difficult for newer firms, with the proportion of investors prepared to commit capital to first-time managers falling over recent years; institutions increasingly look for firms with a long and strong track record when carrying out due diligence to make new commitments.

Investor Appetite

Fund managers have reported an increase in appetite for real estate, with 84% saying they have seen more investor appetite over the past year, particularly from pension funds and sovereign wealth funds. Investors are increasingly global, with Asian institutions in particular moving from domestic-focused to international real estate exposure. Many institutions do remain inactive, however, with 50% of investors not expecting to allocate any fresh capital to real estate in 2015.

Larger investors continue to seek greater control over the direction of their capital. The proportion of investors targeting separate accounts or joint ventures continues to increase, while two-thirds of investors that manage assets of $10bn or more look for co-investment opportunities alongside the managers they invest with.

In the medium to longer term, the real estate asset class is only going to see more institutional capital. Fifty-five percent of investors with a real estate allocation are below their strategic targets to the asset class, while 35% plan to up these targeted allocations in the longer term. Just 5% are planning to lower their allocation to real estate.

Outlook for 2015

There are many challenges facing both fund managers and investors active in the real estate space. For fund managers, high pricing makes finding attractive opportunities challenging, while the fundraising market is more competitive than ever. Institutional investors, which are receiving high levels of distributions from existing commitments, must find the best opportunities to put this capital back to work. Nevertheless, there is a great deal of institutional confidence in the real estate asset class and its ability to meet portfolio objectives, and fund managers are confident in their ability to invest the more than $200bn of dry powder they have at their disposal. Fundraising will remain extremely difficult in 2015, and there will be plenty of firms that struggle, but for those managers that can differentiate themselves from the rest, there is certainly the investor appetite for them to be very successful in the coming year.

Pricing of US Real Estate: A Matter of Perspective

- Greg MacKinnon, Director of Research, PREA

As we near the end of 2014, the US commercial property market continues to surprise to the upside. As of Q2 2014, the PREA | IPD U.S. Property Fund Index showed a trailing one year return of 13.2% (gross of fees). This continues a strong rebound seen in US real estate since the financial crisis, especially in core property and in the major, gateway markets.

This strength has come against a background of economic recovery, with the US economy more attractive than many other potential capital destinations globally. The shine is off the BRICs (Brazil, Russia, India, China) to a large extent, with investors realizing that those markets require larger risk premia than they were previously underwriting. The economies of Europe continue to languish, and the Japanese economy has lagged expectations following a sales tax increase. Given the relative strength of the US economy, and a supply pipeline of new properties that remains below historical levels, healthy returns on US real estate are perhaps not surprising. But, as always, there are risks.

The risk most often discussed for the US property market is of rising interest rates. With the Fed having ended quantitative easing, and a consensus that it will start raising short term rates in 2015, the possible effect of higher interest rates is on the mind of investors. The greatest risk is in the major markets, and in core assets in particular, where current pricing is the richest and which have seen large capital inflows in recent years.

Despite the fears, interest rates have actually fallen through 2014, a testament to the capital markets' almost insatiable appetite for high quality fixed income. Combined with US inflation that remains below the Fed's target, this would seem to indicate that the risk of a rapid rise in rates is low. Nevertheless, given the amount of capital chasing deals major market core has seen extremely low cap rates, leaving open the possibility that even a relatively modest rise in rates could reverse values. There is little doubt that there is a lot of capital out there; Preqin data shows closed-end funds' dry powder in the US has risen significantly the last two years and is at levels well above those seen pre-crisis. But the question is: Is there too much capital chasing deals? Have prices, especially of major market core, been driven up too much and at risk of a fall should interest rates rise?

When considering that question, it is important to remember that a significant portion of capital coming into the US is cross-border. Preqin data indicates that 19% of capital raised for US-focused closed-end funds was from non-US based investors between 2011 and 2014. Furthermore, 56% of Asia-based investors, and 71% of European investors, intend to increase their real estate allocations over the long term, compared to only 26% of US-based investors. This does not indicate that US investors are more bearish on real estate, but rather that many real estate programs in the US are mature, whereas many investors in Asia are relatively new to the asset class and still ramping up their investment program. Cross-border capital sources have surged recently, and will likely continue to become increasingly important to the US market.

But many non-US investors, especially from Asia, view real estate differently than traditional US-based investors do. The PREA Investment Intentions Survey, done in conjunction with INREV and ANREV, shows that Asia-Pacific-based investors place a relatively high value on diversification as a reason to include real estate in the overall portfolio; for US-based investors diversification is important, but so are the income and inflation hedging aspects of real estate. In general, Asian investors place a greater emphasis on the perceived safety of US real estate and its ability to reduce risk. Furthermore, recent research at PREA shows that a different emphasis on diversification can lead to significant differences in how investors view the returns to real estate.

Essentially, when investors view an investment differently, they also view returns, and therefore valuations, differently. Whereas a US investor may look at current prices of core properties in major markets as overpriced, some Asian investors might look at exactly the same properties and see them as fairly priced, given the role they want those assets to play in their portfolios. This does not mean that prices for gateway city core are too high or in a "bubble", only that they are too high for some investors, while potentially being perfectly reasonable for others.

Whether core prices are too high is, therefore, a matter of perspective. As long as cross-border capital remains interested in the US property market then cap rates for core may remain low even with a modest rise in interest rates. Whether capital continues to flow cross-border is, of course, the big question, and therefore a source of risk.

The Pension Real Estate Association (PREA)

The Pension Real Estate Association (PREA) is a non-profit trade association for the global institutional real estate investment industry. PREA's almost 800 corporate member firms from across the United States, Canada, Europe and Asia include public and corporate pension funds, endowments, foundations, insurance companies, investment advisory firms, REITs, and industry service providers.

PREA's mission is to serve its members through the sponsorship of objective forums for education, research initiatives, membership interaction and the exchange of information.

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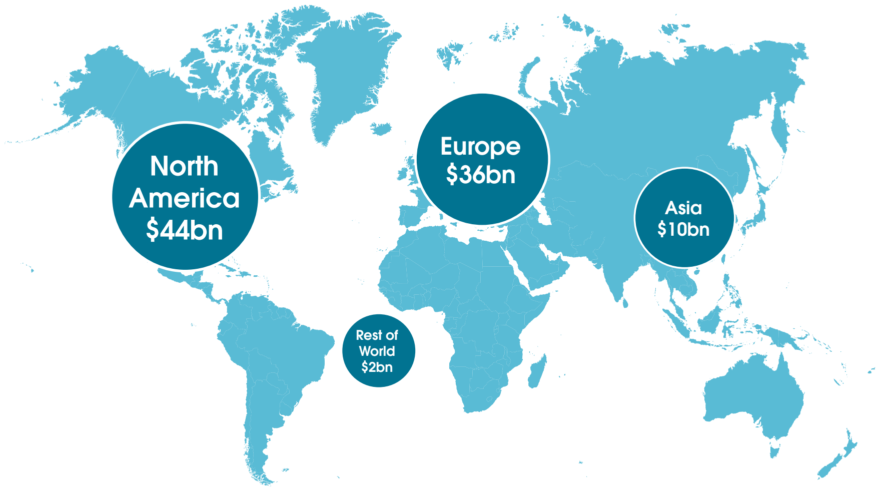
Key Fundraising Stats

2014 Fundraising by Region



19 Average number of months spent on the road by funds closed in 2014.

59% Proportion of funds that reached or exceeded their target sizes in 2014.

72% Proportion of managers that believe there is more competition for investor capital than 12 months ago.

Europe Increases in Prominence

$890mn Average size of Europe-focused funds closed in 2014, up from $428mn in 2013.

39% Proportion of capital raised globally in 2014 focusing on Europe.

Strong Year for Debt Funds

$4.7bn Increase in capital raised by debt funds in 2014 compared to 2013.

$816mn Average size of debt funds closed in 2014.

A Bifurcated Market

59 Decrease in number of funds closed in 2014 compared to 2013.

40% Proportion of total capital raised by the 10 largest funds to close in 2014.

Data Source:

Preqin's **Real Estate Online** contains detailed information on all aspects of the fundraising market, with extensive profiles for over 450 funds currently being marketed and 3,300 closed historically.

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highlights the median and weighted net multiples for funds of vintage years 1995-2014. The weighted net multiple (1.90x) considerably exceeds the median net multiple (1.57x) for 2002 vintage funds, suggesting that larger funds of this vintage are outperforming smaller vehicles. However, larger 2006 vintage funds did not perform as well as their smaller counterparts, which is evident from the weighted net multiple of 0.62x and median net multiple of 1.12x.

J-Curve

The median net IRR at each quarter-end for funds of vintages 2004-2011 can be observed in Fig. 6.5, illustrating the impact of the downturn on funds of 2005-2007 vintage years. The median IRRs of vintage 2007 funds experienced a significant decline that began in June 2008, with the net IRR reaching a low of -41.8% in March 2009. However, the median IRR for funds of this vintage has since had a steady recovery, standing at 3.9% as of June 2014. 2005 and 2006 vintage funds, which would have invested the majority of their capital at peak pricing, have not seen the same level of recovery.

Performance by Strategy and Geographic Focus

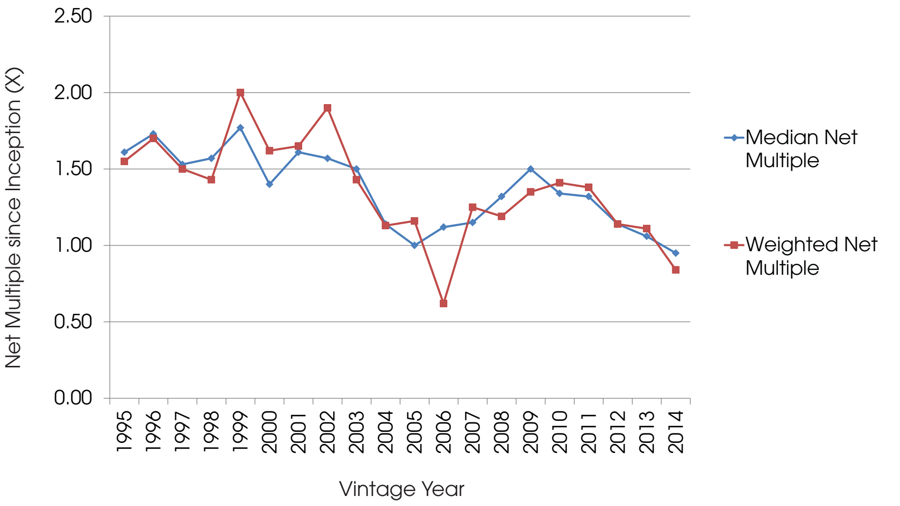
Fig. 6.6 charts the median net-to-investor returns of value added and opportunistic vehicles of vintages 1998-2011. Generally, the fund performance of opportunistic and value added strategies exhibits a similar trend, but performance for the opportunistic strategy has seen more fluctuations between vintages than that of value added vehicles.

The median net IRR for different vintage years between 2005 and 2011 by primary regional focus can be observed in Fig. 6.7. No Asia-focused vehicles have median net IRRs in the negative range, with Asian markets less impacted by the global economic downturn when compared to North American and European markets. 2010 vintage Asian vehicles are also proving to be relatively strong performers, achieving a median net IRR of 22.7%, while the economic recovery in the US and some European markets is reflected in the strong IRRs generated by 2011 vintage funds targeting these regions.

Relationship between Successor and Predecessor Fund Quartiles

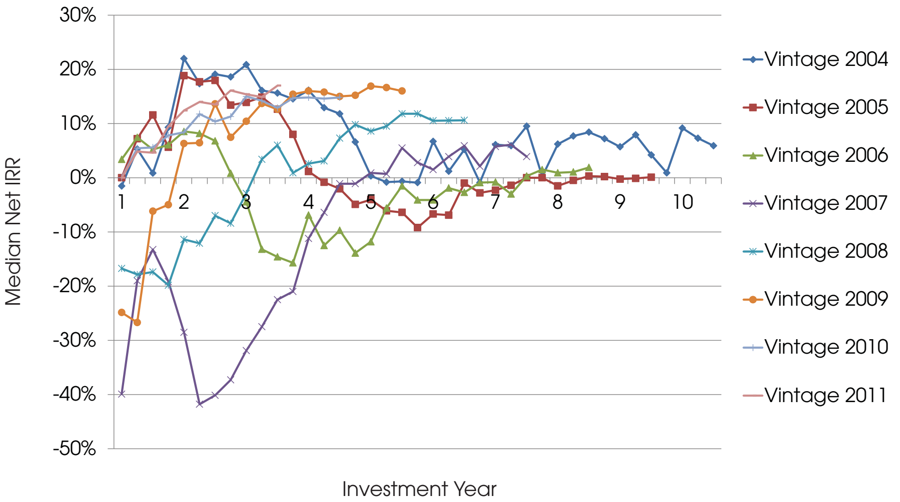
A good track record is one of the most important factors investors look at when it comes down to fund selection, and Fig. 6.8 illustrates just how important this

Fig. 6.4: Closed-End Private Real Estate Funds: Median and Weighted Net Multiples by Vintage Year (As at 30 June 2014)



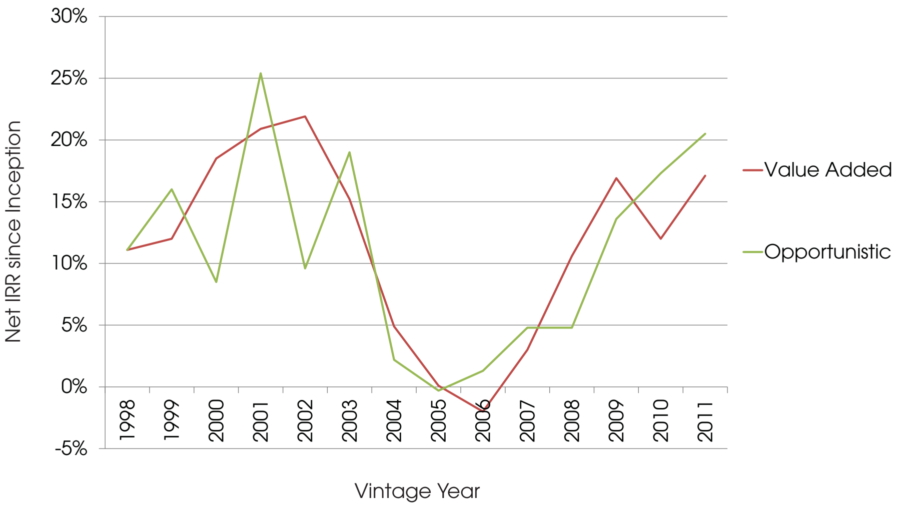
Source: Preqin Real Estate Online

Fig. 6.5: J-Curve: Annual Median Net IRRs by Vintage Year (As at 30 June 2014)



Source: Preqin Real Estate Online

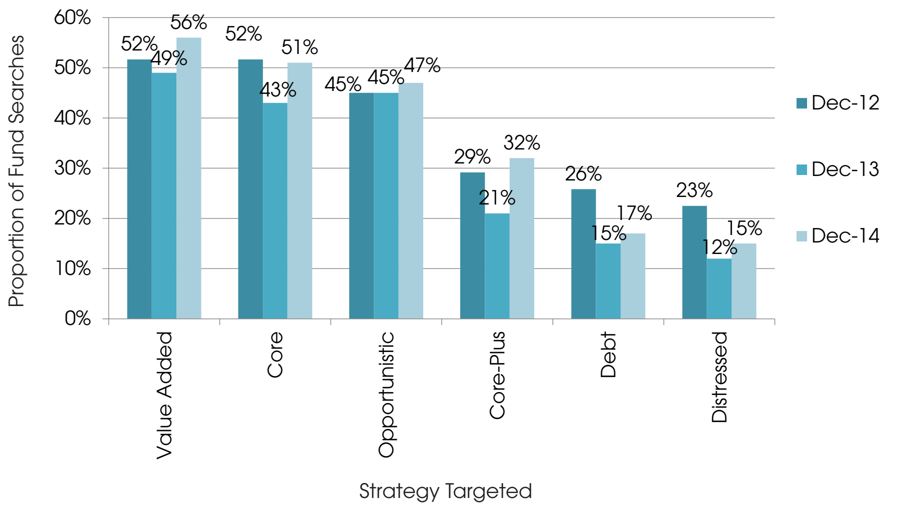
Fig. 6.6: Closed-End Private Real Estate Funds: Median Net IRRs by Vintage Year: Value Added vs. Opportunistic Funds



Source: Preqin Real Estate Online

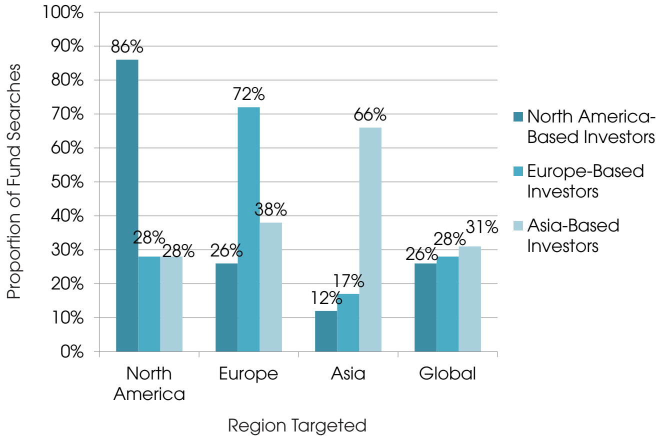
with 37% identifying this as a key issue (Fig. 7.16). The availability of investment opportunities is a key concern for 27% of respondents, with highly competitive asset valuations meaning many investors have concerns about whether there are sufficient attractive opportunities for their capital to be put to work. The economic environment and its impact on real estate performance is a key concern for 25% of respondents.

Fig. 7.14: Strategies Targeted in the Next 12 Months by Private Real Estate Investors, December 2012 - December 2014



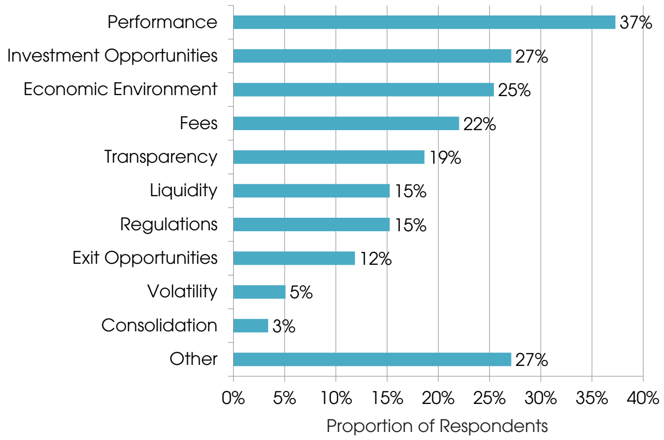
Source: Preqin Real Estate Online

Fig. 7.15: Regions Targeted in 2015 by Private Real Estate Investors by Location



Source: Preqin Real Estate Online

Fig. 7.16: Investors' Views on the Key Issues for the Private Real Estate Market in 2015

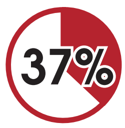


Source: Preqin Investor Interviews, December 2014

In Brief:

A third of investors believe their real estate fund investments have exceeded expectations over the past 12 months.

Proportion of investors that plan to commit more capital to real estate in 2015 than in 2014.



Proportion of investors that view performance as the key issue in the private real estate market.

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Real Estate Online features in-depth profiles of over 4,700 institutional investors actively investing in real estate, including allocations to real estate, assets under management, information on current fund searches and open mandates, direct contact details for key decision makers and much more.

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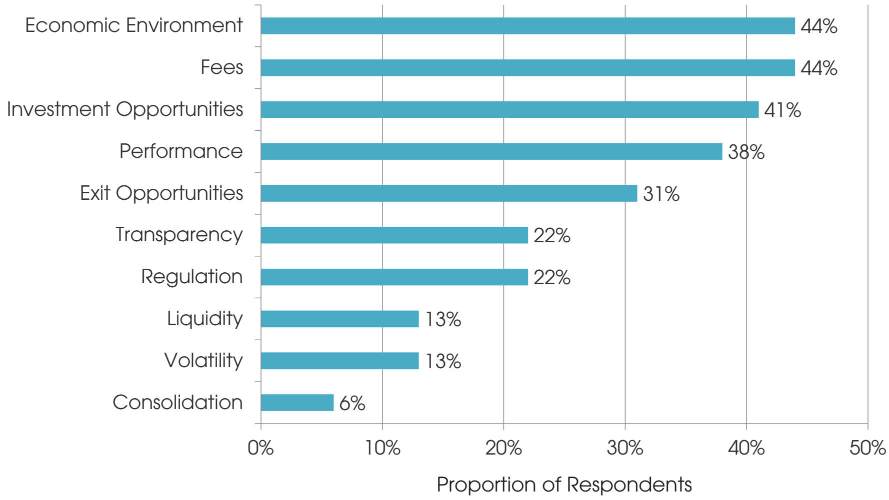
are paying fund managers (see page 61), 44% of consultants consider fees an important issue.

Regulation was not considered an important issue by many consultants, with only 22% citing this as a key issue. When asked specifically about the impact of regulation on their business, while 30% felt it had been negative, 59% felt there was no impact and 21% said it had positively impacted them. One consultant commented that “too many people complain about aspects [of regulation] that are simply good practice.”

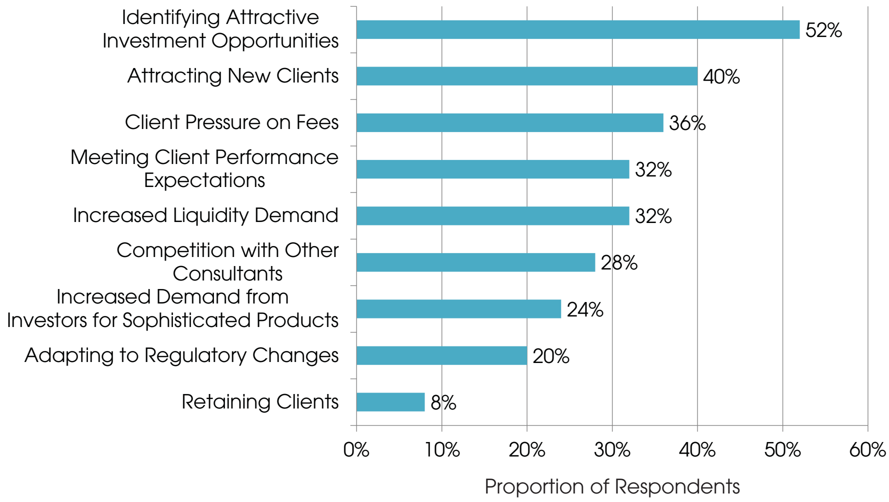
The factors that investment consultants view as the biggest challenges for their business in 2015 again highlight the concerns regarding the pricing of real estate assets and the impact this has on their ability to source attractive opportunities for their clients. Attracting clients and meeting their clients’ demands for performance and fees are also significant challenges for many consultants.

Fig. 13.7: Investment Consultants’ Perception of the Most Important Issues in the Real Estate Market



Source: Preqin Investment Consultant Survey, November 2014

Fig. 13.8: Investment Consultants’ Views on the Biggest Challenges Affecting Their Businesses in 2015



Source: Preqin Investment Consultant Survey, November 2014

Key Facts:

290 Number of investment consultants globally that provide advice on real estate investments.

78% Proportion of investment consultants that recommend their clients have a real estate allocation of 6% or more of total assets.

33% Proportion of consultants that plan to advise their clients to invest more capital in 2015 than in 2014.

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