Preqin Research Report
PERE Investor Survey: Looking Back and Moving Forwards (1)

In Q4 2009, Preqin carried out a survey of 90 institutional private equity real estate investors to investigate their attitudes towards private equity real estate and their intentions for the asset class in 2010. Preqin spoke to investors of varying size, type and geographic location about their private equity real estate activity in 2009 and how they would approach the market this year. This article reports the results of that survey and discusses the changed investor mentality, as well as providing an overview of the private equity real estate market as it stands today. With a difficult 2009 behind them, what can we expect from private equity real estate investors in 2010?

Cautious and Uncertain: The New Private Equity Real Estate Investor

The last 18 months have been difficult for private equity real estate investors and fund managers alike. Fund managers struggled to secure commitments for their funds and overall fundraising dropped significantly. This decline in fundraising was a direct consequence of an investor universe that was committing less capital to the industry than in recent years. Some investors reduced their usual capital outlay to the industry, whilst others temporarily halted investments altogether. Although the industry has continued to garner some commitments, investors are being more cautious when allocating fresh capital to the market.

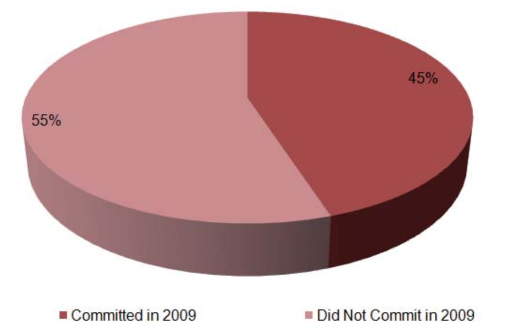
Effects of the Economic Downturn

The credit crunch sent property prices in a downward spiral throughout 2009, and many investors were extremely cautious about investing in the asset class. Furthermore, many investors were affected by falls in other areas of their portfolios, which raised allocations to real estate until valuations later in the year readjusted their positions. However, many in the early months of 2009 were concerned by their over-weighting to real estate and many were bound by rigid investment guidelines that prohibited investing in real estate whilst over-allocated.

Although in many cases allocation levels readjusted themselves, a sense of caution prevailed. In such uncertain economic times, many expressed a desire to retain a greater level of liquidity in their real estate and general investment portfolios. Accordingly, the closed-end nature of private equity real estate stopped many from investing in 2009. Liquidity issues were worsened by the falling distributions made by many private equity real estate managers, meaning that capital that was perhaps earmarked for re-investment was no longer available. Moreover, with so much dry powder available but unspent and with so many commitments made but uncalled, many investors saw little point in investing in 2009.

Despite the gloom, many investors did not lose confidence in the long-term benefits of investing in private equity real estate, they simply were not investing in 2009. Many private equity real estate investors, including some rather prominent institutions, decided to delay investing in the asset class until the markets had settled. Some delayed until Q4 2009, whilst others suspended private equity real estate programs until 2010 or later. Institutions made these decisions not knowing how long the market would take to recover and some have since had to reconsider their strategies.

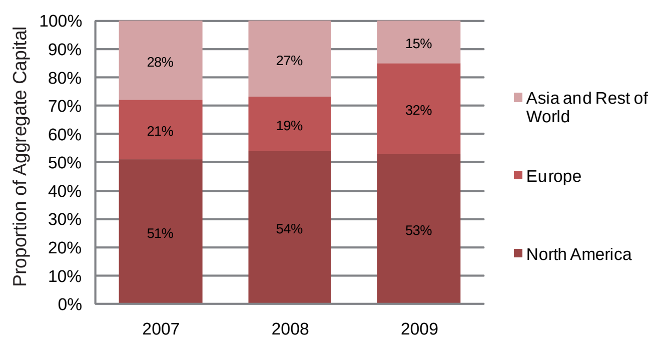
Fig. 1: Proportion of Private Equity Real Estate Investors Committing to Funds in 2009



Investor Inactivity in 2009

The results of Preqin's survey of 90 institutional investors reveals just how big a shift there has been in the attitudes and capabilities of investors. As can be seen in Fig. 1, 55% of respondents did not commit to new funds in 2009. This is in stark contrast to the results of Preqin's investor survey conducted in Q4 2008, when 84% of respondents stated that they would be making fund commitments in 2009. As already outlined, there were many reasons why investors refrained from investing in 2009. The respondents in Preqin's 2008 survey obviously did not foresee the problems

Fig. 2: Breakdown of Aggregate Capital Committed by Region



in the market and therefore had to adjust their investment plans. Many of these concerns are still relevant this year, as the long-lasting effects of the credit crunch and market dislocation are yet to be resolved.

Location and Strategy Focus of Investors That Committed in 2009

Many investors that did make commitments in 2009 focused on vehicles closer to home. The unwillingness of many investors to take risks on less familiar markets led to a lower proportion of capital being allocated to Asia and Rest of World, markets that had been enjoying significant growth over the past few years. Fig. 2 shows that, while Asia and Rest of World funds received 28% and 27% of capital commitments in 2007 and 2008 respectively, this decreased to 15% in 2009.

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The strategic preferences of investors in 2009 remained similar to 2008 and, as Fig. 3 shows, value added and opportunistic funds are by far the most targeted strategies. In 2009, 73% of all private equity real estate investors were interested in value added vehicles and 73% were interested in opportunistic funds. These figures are similar to the corresponding figures in 2008. There was a small increase in interest in lower-risk core-plus funds; however, the major difference seen in 2009 was in the distressed and debt fund sectors, with investors and fund managers wanting to take advantage of the opportunities in the dislocated market. 30% of investors stated an interest in private equity real estate funds that invest in distressed real estate, compared to 22% in 2008. 36% of those surveyed were interested in funds participating in debt investments, compared to 14% in 2008.

Fig. 3: Private Equity Real Estate Fund Strategy Preferences of Investors

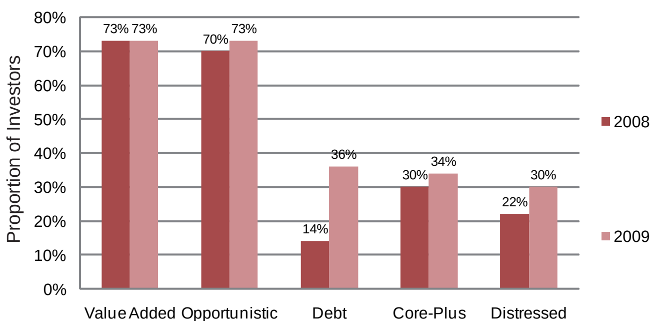
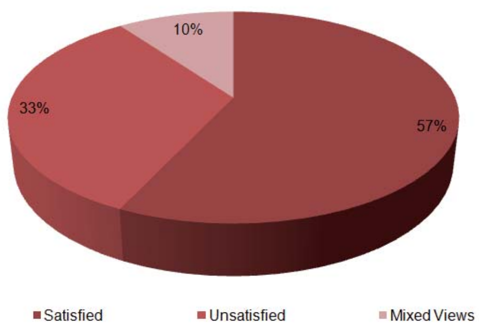


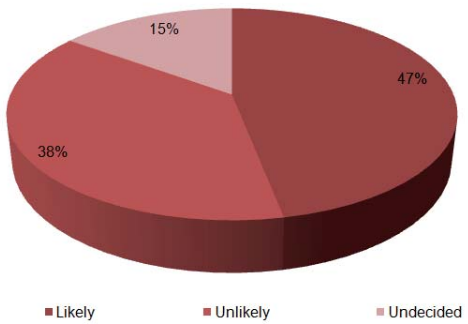
Fig. 4: Investor Attitudes Towards 2009 Private Equity Real Estate Portfolio Performance



Satisfaction with 2009 Portfolio Performance

With fund performance down in 2009 compared to previous years, it would not be unreasonable to expect investors would be disappointed with the performance of their private equity real estate portfolios. However, it seems that investors have a more realistic stance when judging performance in 2009, taking into account the various factors affecting their portfolios. Of those surveyed, 57% were satisfied with the performance of their portfolios in 2009. However, Fig. 4 shows that 33% of respondents stated that they were unsatisfied with their private equity real estate portfolios, with a number of these investors disappointed at how the funds in their portfolios had performed. 10% had mixed views on the performance of their portfolios: happy with the performance of some funds, unhappy with the performance of others. Therefore, despite a testing year, many investors felt their portfolios performed to satisfactory levels in 2009 considering the downturn in real estate markets and the adjustments that fund managers had to make.

Fig. 5: Likelihood of Investing in Private Equity Real Estate in 2010



Investor Activity in 2010

Despite the difficulties experienced in 2009, it seems many investors have maintained confidence in the market and are willing to invest in the asset class in 2010, although they will be more cautious and implement stricter due diligence than in the past. From the results of the survey, it is evident that investors are taking more precautions when managing their real estate portfolios. They are now more likely to analyse various factors that can influence future investments, including distributions from existing fund investments, which, for some investors Preqin spoke to, will determine the level of activity in private equity real estate in 2010. Distributions from private real estate funds had not been such a major concern before the credit crisis when investors were receiving them at such a high rate.

"Of those surveyed, 57% were satisfied with the performance of their portfolios in 2009."

As Fig. 5 shows, only 47% of respondents said that they were likely to commit to private equity real estate in 2010. 38% said they were unlikely to make any fund commitments and the remaining 15% had yet to decide whether they would invest in any vehicles in 2010.

The proportion of investors not planning to invest is high compared to previous years, when the asset class became accustomed to receiving a large number of capital commitments from institutional investors. However, considering the turmoil in the financial markets and the drop in property valuations, it is encouraging to see that nearly half of all respondents plan to make a commitment to a private equity real estate fund in 2010.

The 15% that had not decided on their stance on private equity real estate activity for 2010 highlights the cautious

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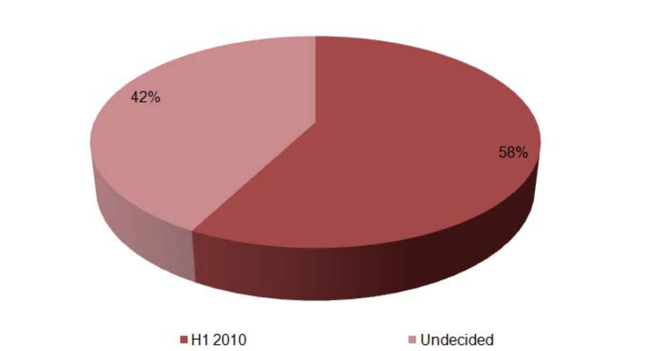
approach many investors have taken recently. Investors are no longer formulating concrete investment plans. They are not setting parameters on the number of funds and the amount of capital they plan to invest in the following year; instead they are employing a wait-and-see approach, opting to assess the market and investing only if the opportunity is highly attractive. Only 29% of those that said they would invest in 2010 could estimate the number of funds they would invest in, and only around 24% had an approximate figure in mind for the amount of capital they would commit. This is much lower than in previous years, when the majority were able to predict both the number of funds and the amount of capital they would invest over the following 12 months. Nonetheless, as the investment environment remains uncertain much can still change. Those that were undecided about their activity in 2010 may opt to make commitments by the end of the year if the market becomes more favourable, especially as many spoke of market conditions being a major factor in their decisions. Similarly, some of the investors that were hoping to invest this year may not implement those plans, due to less frequent distributions and reduced amounts of capital to invest. However, it is unlikely that the difference between those planning to invest and those that end up making commitments in 2010 will be as high as the difference in 2009.

Fig. 6: Timing of Next Private Equity Real Estate Fund Commitment

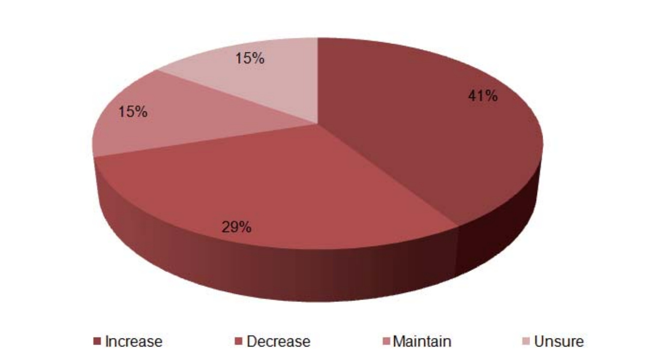


It is important to note that most investors appreciate that a number of new issues may surface in 2010 and the market remains turbulent to some degree. Financing will remain an issue for real estate fund managers as they will need to refinance existing projects and deals that they originally acquired loans for in 2005 and 2006. Managers need to be aware of the specific requirements of investors and meet their expectations if they are to garner new commitments.

Timing of Next Fund Commitment

When the investors that were looking to invest in private equity real estate in 2010 were asked when they would make their next fund commitment, 58% expected it to occur in the first half of the year. The remaining 42% were unsure of or had not decided the exact timing of the commitment. This further underlines the fact that many investors are vigilant in this market and are waiting for the right opportunities to present themselves rather than being proactive and setting timeframes for fund commitments. Of those that planned to invest in H1, only a small number could specify in which quarter this would be.

Fig. 7: Changes in Private Equity Real Estate Allocations in Next 12 Months



Location and Strategy Focus in 2010

When asked which geographic regions they would target in 2010, many investors favoured domestic markets and regions that they had gained exposure to in the past. Emerging economies such as China and India, which were growing in popularity before the credit crunch, have fallen in popularity again as investors look closer to home.

> "Investors are not setting parameters on the number of funds and the amount of capital they plan to invest in the following year; instead they are employing a wait-and-see approach."

In terms of fund strategies, a significant proportion of respondents stated an interest in lower-risk strategies. A number of respondents wanted to invest in core and core-plus vehicles. One reason why they are targeting core and core-plus funds is because these vehicles utilise little or no leverage, and investors are concerned about the large amounts of leverage employed by the higher-risk strategies.

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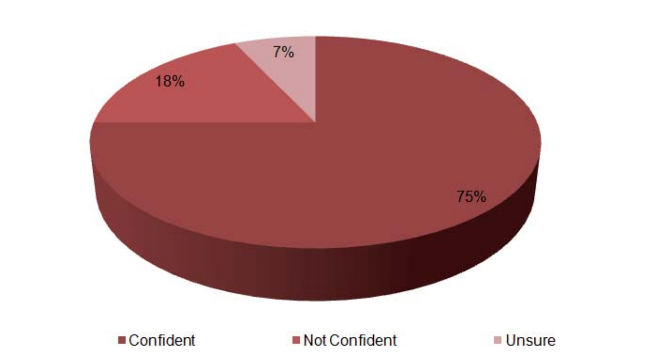
Fig. 8: Investor Confidence in Private Equity Real Estate Market in the Long Term



Whilst interest in the more prevalent opportunistic and value added funds remained at similar levels to previous years, investors are becoming increasingly interested in the growing debt and distressed markets and many also said that they wanted to purchase fund stakes on the secondary market.

Private Equity Real Estate Allocations in Next 12 Months

When asked about their allocations to private equity real estate in the next 12 months, 41% of investors believed that it would increase, whilst 29% expected it to decrease. 15% said they would be maintaining their allocations and the remaining 15% were unsure.

Confidence in Private Equity Real Estate

The relatively high proportion of private equity real estate investors looking to commit to funds in 2010 and looking to increase their allocations to private equity real estate suggests that confidence is returning and investors are feeling more optimistic about the asset class. Fig. 8 shows that 75% of investors surveyed are confident in the private equity real estate market in the long term. They still view fund investments as an important part of their portfolios and are willing to remain active in the market over the long term. Although 18% are not confident in the asset class, none of the investors Preqin surveyed have deserted private equity real estate completely following the turmoil in the economy. Most have only been halting investments in the short term and are hoping to return when they themselves are in a better position or when the market improves.

Conclusion

Last year was particularly challenging for the private equity real estate industry. Fund managers struggled in their fundraising efforts and investors were reluctant to commit to real estate funds. Preqin's survey found that 55% of private equity real estate investors did not commit to new funds in 2009. With valuations falling and many institutions struggling with liquidity issues, it is not surprising that investors have been cautious.

Those that were active in 2009 typically invested closer to home, and in terms of strategy focus, 2009 saw debt and distressed funds rise in prominence. Despite a testing year, many investors felt that their portfolios performed to satisfactory levels in 2009 considering the the downturn in real estate markets.

The results of our survey show that investors are still interested in private equity real estate and many plan to invest this year. However, many are still unsure or are not willing to commit to the industry in 2010, preferring to wait for a longer period of time. A significant proportion of investors that will commit in 2010 are uncertain of the amount of capital they will deploy, the number of commitments they will make and the timing of those commitments. This lack of structure is uncharacteristic for an industry that has been more decisive in the last few years. Those investing are less likely than they were to invest beyond familiar regions, and lower-risk fund investments, as well as debt and distressed funds, have grown in popularity.

It is encouraging that investors have not lost confidence in the market and most will resume investments in the asset class at some point in the future. However, the ever-changing market remains a difficult one to predict. The majority of investors that Preqin spoke to were uncertain as to whether the market had bottomed out, but many were hoping that it would begin to recover this year. It will take a great deal of effort from fund managers to secure investor commitments in such a saturated and uncertain market. Although investors are willing to commit to the asset class, the emphasis is on fund managers to present them with the right opportunities.