What Now for Private Equity Real Estate?

A Preqin Special Report

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The private equity real estate market has seen a dramatic change in its fortunes over the past two years. Prior to 2008, fundraising was increasing year-on-year, investors were rushing to commit to new funds and returns were strong. The past two years, however, have been characterized by poor performance, investor inactivity and slow fundraising. There are some signs the market may be improving, but in turbulent conditions, predicting when this will happen is a difficult proposition.

Investor Attitudes

Fundraising has been slow throughout 2009 and 2010 to date, with quarterly totals ranging from $7.6 billion to $15.4 billion. In comparison, quarterly totals ranged between $24.2 billion and $43.8 billion during the period 2007 to Q3 2008. The primary driver behind the slow fundraising has been investor inactivity and caution. Preqin's recent real estate investor survey found that just 24% of investors made a real estate fund commitment in H1 2010.

During the boom years, investors were continually receiving returns from their existing private equity real estate investments, which they were then re-investing in new funds. As a result of the economic downturn, investors are receiving far fewer distributions from their existing funds and therefore are not investing new capital at the same rate. In many cases, investors have large amounts of capital committed to funds that remains uncalled. For other investors there is no urgency to commit. With uncertainty surrounding future real estate valuations, institutions do not feel they are missing opportunities by staying on the sidelines.

The same survey does, however, give indications of a possible improvement in fundraising in the future. 42% of investors surveyed are planning to make new commitments in the next 12 months, while another 19% indicated they would consider doing so. This does not suggest that a dramatic upturn in fundraising is imminent, but does suggest that quarterly fundraising totals will begin to increase over the coming year.

Performance

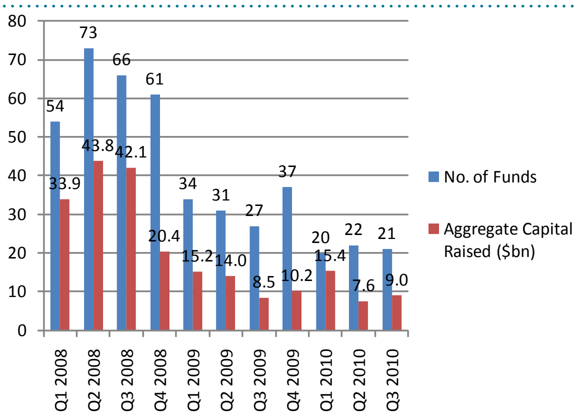
The performance of private equity real estate funds has been severely impacted by the economic downturn, with funds of 2006 and 2007 vintages most adversely affected. Two-thirds of 2006 vintage funds and 79% of 2007 vintage funds are currently producing negative IRRs. Recent performance is not showing any signs of a quick reversal of fortunes, and real estate has lagged behind other asset classes which have seen a rebound in performance.

As Fig. 2 illustrates, recent performance for private equity real estate funds has been mixed. 2007 vintage funds, although deep in the red, have seen performance improve over recent quarters. 2005 vintage funds, in contrast, have seen declines in the median IRR in recent quarters. Clearly with many funds still suffering, fund managers will be concentrating on asset management and restructuring debt, with the aim of turning the fortunes of their funds around.

A Crowded Market

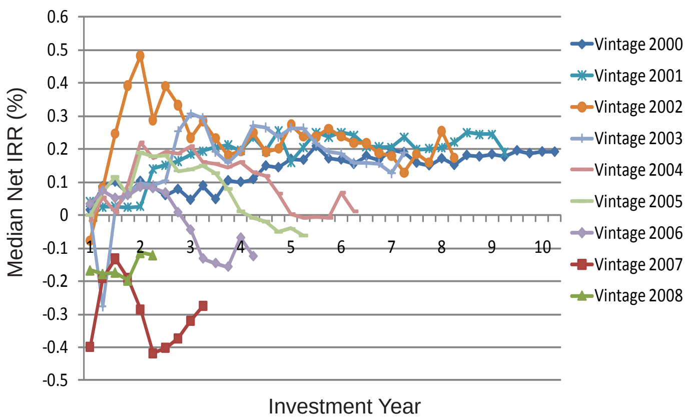
The aggregate target of funds in market has fallen steadily since Q1 2009, but there are still 400 funds in market, targeting aggregate commitments of $129 billion. Between January and September 2010, 47 funds were abandoned or placed on hold, highlighting that fundraising remains an extremely challenging prospect. While for some firms fundraising has proven to be

Fig. 1: Quarterly Private Equity Fundraising, Q1 2008 - Q3 2010



Source: Preqin

Fig. 2: J-Curves - Annual Median Net IRRs by Vintage Year



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impossible, there are signs for others of an improvement in fortunes. In 2009, just 15% of funds met or exceeded their fundraising targets, with 85% falling short. Between January and September 2010, however, 19% of funds to close have done so on target, while 24% have exceeded their targets.

Although it is clear that not every fund in market will be raised successfully – the aggregate target of all funds in market is more than two and a half times the amount of capital raised in 2009 – the paralysis in the fundraising market that was evident a year ago appears to be easing. Firms raising funds that fit with the revised aims of the institutional investor community have been successful in raising capital.

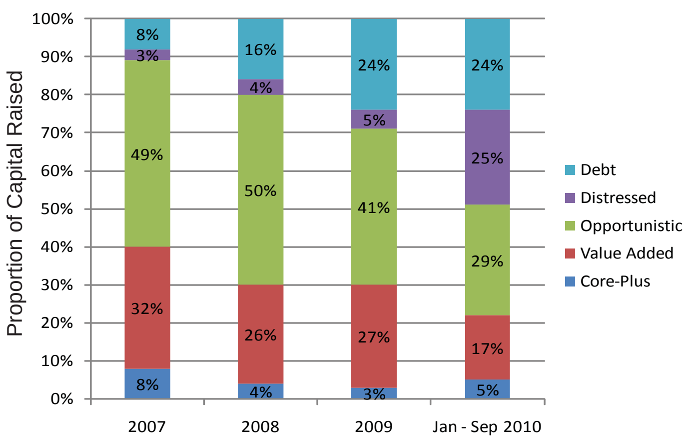
A Changing Approach

The changing nature of the real estate market has led to dramatic shifts in the strategy preferences of institutional investors and the strategies of funds which are being launched. The rise in the appeal of core funds has been marked, with 86% of investors now having a preference for this type of vehicle. Fundraising for value added vehicles has declined significantly. Value added funds were responsible for 32% of capital raised in 2007, but only accounted for 17% of capital raised in January to September 2010. Opportunistic strategies have seen a smaller proportional decline. Many investors have also seen the appeal of distressed opportunities and real estate debt. Debt funds accounted for 24% of capital raised in January to September 2010, with distressed funds accounting for 25%.

Dry Powder

While fundraising may be slow, this has not had a significant impact on the amount of capital that private equity real estate fund managers have at their disposal to make new investments. As of September 2010, these firms had $174 billion in uncalled capital. If real estate fund managers feel there are excellent opportunities available (and that remains a big if), they are in a good position to take advantage. North America-focused funds have $98 billion of capital to call up, Asia and Rest of World-focused funds have $39 billion and Europe-focused vehicles have $37 billion.

Fig. 3: Breakdown of Annual Capital Raised by Strategy, 2007 - September 2010



Source: Preqin

It is obvious to all within the private equity real estate industry that a return to the fundraising levels of 2006 and 2007 will not happen quickly, if ever, but there are some encouraging signs for fund managers. Many investors that spent much of the past two years on the sidelines are showing signs of returning and do plan to make new commitments in the next 12 months.

Fund managers still have $174 billion of uncalled capital available to invest and, despite fundraising remaining slow, some strategies are appealing to investors and capital is being raised for these funds. While most institutions do not feel they will be adversely affected by delaying new commitments at present, if the number of transactions taking place picks up, fund managers call up capital and investors receive distributions from their existing investments, then institutions are likely to return to the market in greater numbers. Fund managers that have adapted to the changing attitudes of the institutional investor community and successfully conveyed how they intend to overcome market conditions have shown that it is possible to raise capital for new funds.

Institutional Investors

Investor Location

- Institutional investors from around the globe make private equity real estate investments. North American institutional investors constitute over half (55%) of all investors in the private equity real estate asset class.
- The proportion of investors from Europe is 31%, with Asia and Rest of World comprising 11% of investors in private equity real estate funds.
- The percentage of investors from North America has slightly dipped from a year ago, from 58% to 55%, while the share of European investors has increased from 31% to 34%. The proportion of Asia and Rest of World investors in the asset class has remained constant at 11%.
- The private equity real estate industry attracts commitments from a wide range of institutional investors.
- The most numerous type of investor in the private equity real estate asset class is public pension funds, with this group representing 29% of investors interested in this investment category. Some of the most prominent and established private equity real estate investors are public pension funds.
- Private sector pension funds represent the second-largest investor category in private equity real estate, accounting for 14% of investors. As such, pension funds in general dominate the make-up of private equity real estate investing, highlighting the ability and preference of these types of investors to engage in illiquid, long-term investments.

Investor Type

Fig. 4: Breakdown of Private Equity Real Estate Fund Investor Universe by Region

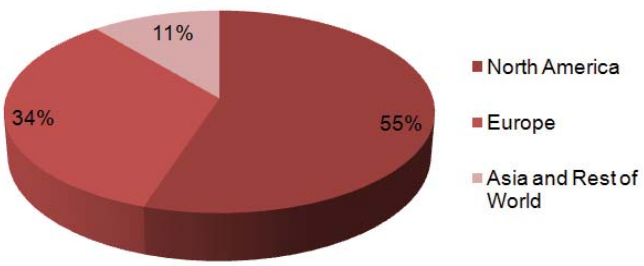


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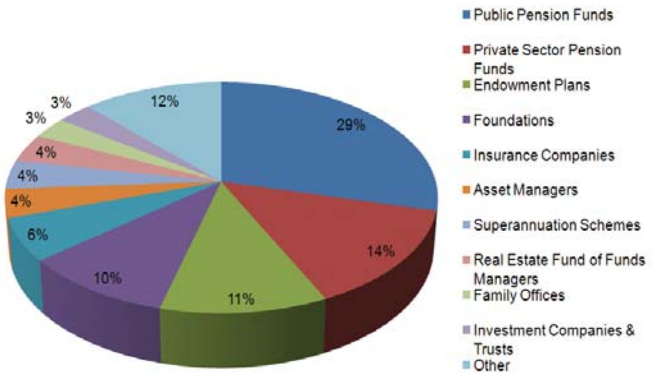
Fig. 5: Breakdown of Private Equity Real Estate Fund Investor Universe by Type



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Funds

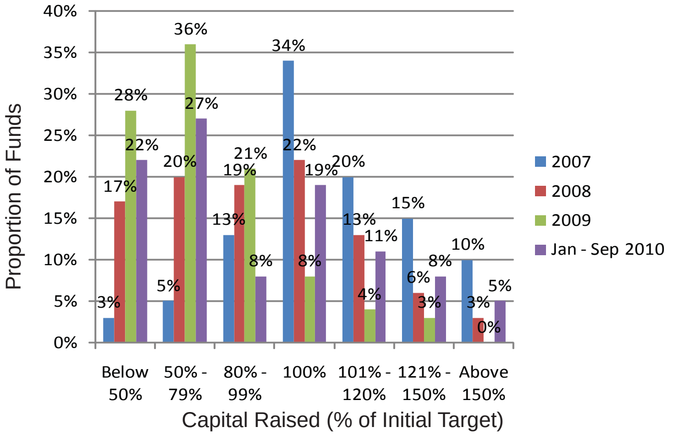
Success in Achieving Fundraising Target

- In 2007 fund managers had a high level of success in gathering commitments from investors, with 79% of funds meeting or exceeding their original target and 25% of funds closing with more than 120% of their fundraising target.
- In 2008, fewer funds achieved their fundraising goals. This trend continued in 2009, when increased investor caution resulted in just 15% of funds meeting or exceeding their original targets.
- 43% of funds to close between January and September 2010 met or exceeded their fundraising targets. This suggests that the fundraising environment is showing signs of improvement and that fund managers are now setting lower, more realistic fundraising targets.

Current Fundraising

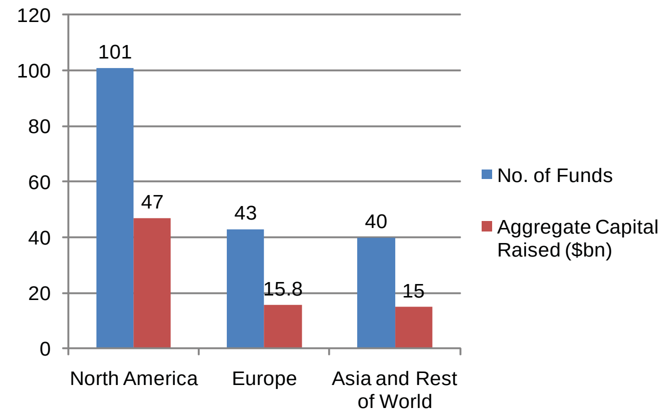
- A significant 60% ($47.0 billion) of the capital raised between 2009 and September 2010 was collected by 101 funds with a primary focus on investments in North America. It is worth noting that many of the largest funds with a primary focus on North America will also make investments on a global basis.
- 43 funds with a primary focus on Europe closed, raising a total of $15.8 billion, and 40 Asia and Rest of World-focused vehicles closed on aggregate commitments of $15.0 billion.
- While fundraising has been poor throughout the market in 2010, fundraising for European funds has been particularly challenging. Primarily Europe-focused funds raised just $1.7 billion between January and September 2010, accounting for 6% of the total capital raised. This is compared to 2009, when European funds made up 29% of the total market.

Fig. 6: Annual Breakdown of Final Close Amounts by Proportion of Target Capital Raised, 2007 - September 2010



Source: Preqin

Fig. 7: Breakdown of Fundraising by Primary Regional Focus, 2009 - September 2010



Source: Preqin

Fund Manager Universe

Fund Manager Location

- Of the 1,035 real estate fund managers globally, 577 are located in North America. Of these, 560 are located within the US, with New York the city in which the largest number of fund managers are based. Of the 11 cities with the highest concentration of real estate fund managers, six are in the US.

- Over a quarter of firms (292) are located in Europe and of the 11 countries in which most fund managers are based, four are European. Following New York, London is the city in which the most real estate firms are located.

- 166 firms are located in Asia and Rest of World. Five countries in this region are included in the list of 11 countries in which most real estate firms are located.

Fund Manager Experience

- As investors frequently consider fund manager experience when selecting a fund it is interesting to note that almost a half, 48%, of firms only manage one real estate fund.

- The majority, 89%, of fund managers have five funds or fewer under management.

- Only 5% of firms have 10 real estate funds or more under management. Of these most experienced firms, 64% are US-based and this category includes some of the most well known fund managers, such as Blackstone Group, Carlyle Group and Pramerica Real Estate Investors.

Fig. 8: Global Distribution of Real Estate Firms by Region

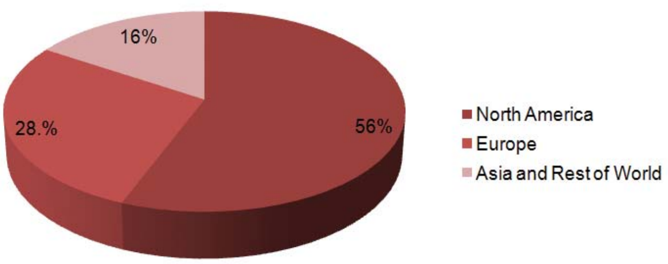


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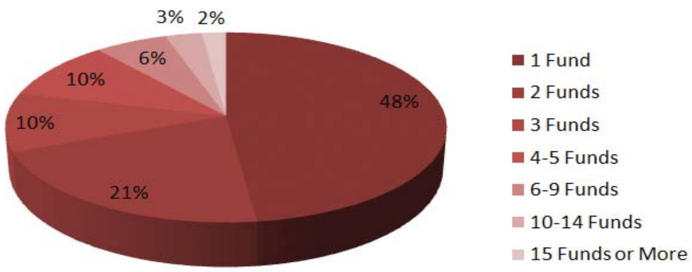
Fig. 9: Firm Experience by Number of Funds Managed



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2010 Preqin Private Equity Real Estate Review - Chapters

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