

## Topics of Interest

# The Advantages of the Private Equity Real Estate Fund Model

Core private real estate funds targeting stabilized, cash flowing assets have attracted significant capital inflows since the global financial crisis. In contrast, commitments to value-add and opportunistic real estate funds have yet to rebound to pre-crisis levels of capital inflows. As noted in the chart below, commitments to private equity real estate funds, the most common vehicle for value-add and opportunistic real estate strategies, totaled \$114 billion globally in 2011 and 2012 combined, well below the peak of \$272 billion in 2007 and 2008, but still a 17% increase over the 2009 and 2010 period. The trend of greater commitments to value-add and opportunistic private equity real estate funds does show that risk appetite among investors is recovering. Also, investors continue to recognize the importance of value-add and opportunistic real estate and the ability of the asset class to generate alpha with carefully selected managers.

## AUTHORS

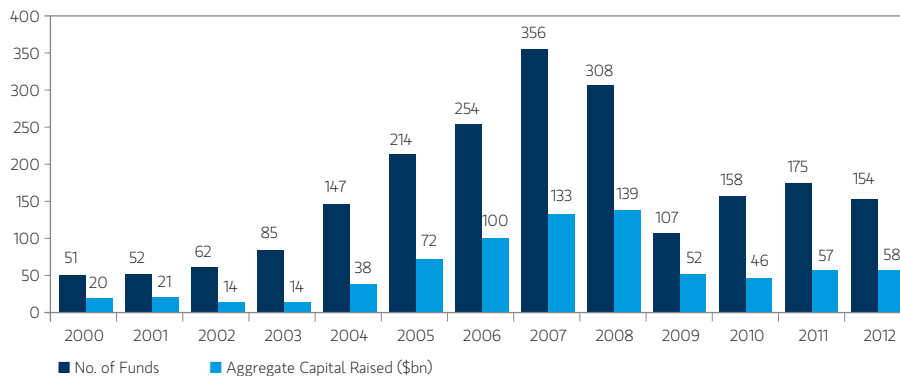


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**Figure 1: Private Equity Real Estate Funds: Number of Funds and Capital Raised from 2000-2012**



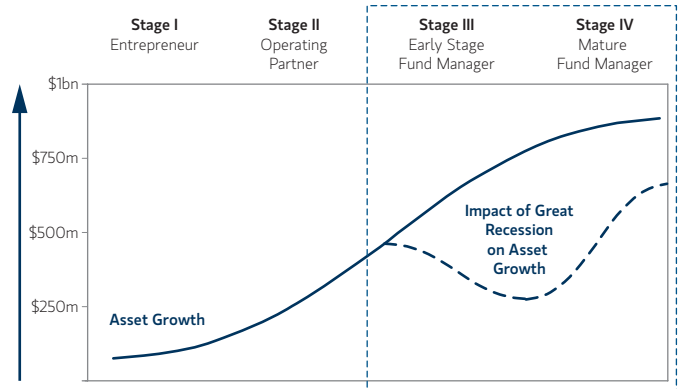
Source: Preqin, January 2013

While commitments have increased to value-add and opportunistic private equity real estate funds, investors are increasingly focused on how to best take advantage of the asset class within their overall portfolios. When conducting diligence on individual fund managers, there has been a renewed focus on whether the managers' returns were generated on a levered or unlevered basis. In addition, the industry has sought to address weaknesses in the private equity real estate fund model. Investors have sought increased transparency with comprehensive reporting.<sup>1</sup> Some investors have sought to obtain more control, with a preference for investing either as the sole limited partner (LP) or alongside a small group of like-minded investors in "club deals" targeting a specific asset or portfolio, as opposed to investing as a limited partner in a private equity real estate fund, where investors' capital is commingled and the fund manager has discretion over investments and business plan execution.

## Private Equity Real Estate Fund Model Benefits

Our view is that discretionary private equity real estate funds are still the most attractive format for gaining exposure to private real estate rather than investing as a sole limited partner or in a club format. First, we believe the most successful and capable real estate investment managers focus their attention on raising private equity real estate funds, as they are the best source of capital for both making investments and building a long-term real estate platform. Private equity real estate fund managers can also have a significant advantage in today's market providing speed of execution and certainty of closing relative to real estate managers that require limited partner approval or individual fundraises for each acquisition. Furthermore, the economics of the fund management model remain attractive to real estate managers, as the steady management fee stream can allow them to build a business that is sustainable in the long-term and to attract the best talent.

**Figure 2: Evolution of Private Equity Real Estate Small to Mid-Size Fund Manager**

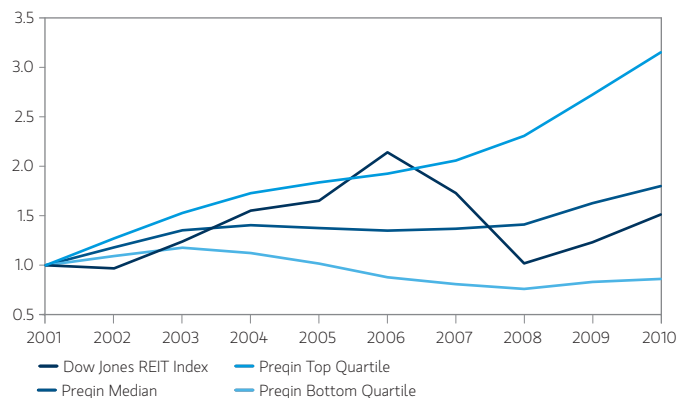


Source: Morgan Stanley Alternative Investment Partners, as of May 2013.

For illustrative purposes only. There can be no assurance that any real estate investment will be profitable.

Second, while there is a significant dispersion of returns among real estate managers, top quartile managers generated a positive return and their performance shows significantly less volatility during the global financial crisis than the overall peer group. Their returns also exhibited low correlation to fixed income and equity markets. This is evident in evaluating the performance of top-quartile private equity real estate fund managers in the Preqin index pre-, during, and post-crisis. As noted in the chart below, where the top-performing private equity real estate funds' returns remained less volatile through the cycle compared to funds in lower quartiles whose performance greatly suffered.<sup>2</sup>

**Figure 3: Preqin Private Equity Real Estate vs Dow Jones REIT Index**



Source: Preqin, January 2013; Yahoo Finance, March 2013

The diagram represents value-add and opportunistic funds with vintage years as shown. Number of funds and managers per vintage years varies.

<sup>1</sup> State Street, Real Estate: A New Model for Fund Managers, December 2011

<sup>2</sup> Morgan Stanley AIP analysis of Preqin data from December 2012

The returns experienced by certain segments of the market have more to do with how those funds were managed, rather than the structure of the private equity real estate fund model. The poorest performing private equity real estate funds share certain characteristics, including strategy mistakes, poor investment choices and risk management, aggressive use of leverage to enhance returns, misalignment of interest with their investor base and an ignorance of the many factors indicating significant danger signals, including the over-leveraging of the real estate markets and the mispricing of risk. The private equity real estate fund model is not fundamentally flawed, but rather the management of certain funds was fundamentally flawed. Important lessons can be learned by our industry in response to the poor performance of certain fund managers and the better performance of the top quartile managers. Set out below are what we believe to be the hallmarks of the best performing fund managers.

## Characteristics of Top Performing Private Equity Real Estate Funds

The three hallmarks of top performing private equity fund managers are a) a disciplined and focused investment strategy, b) a strong alignment of interest with investors, and c) a repeatable track record of producing returns from real estate fundamentals and value added by the management team. In terms of strategy, top-performing funds stayed focused on value-oriented investing in markets and strategies they were familiar with, as opposed to making macro bets or “style drift” into opportunities in sectors that seemed attractive at the time but where they had no prior experience (e.g. ground-up development).

It is hard to replicate the experience and expertise needed to successfully execute such strategies, limiting competition for these top managers. With respect to alignment, top performing fund managers typically generated returns on a fully pooled basis, so that the manager was aligned throughout the term of the fund and focused on exit strategy across every investment. This is in contrast to managers that favored a deal-by-deal carry structure, which leads managers to focus only on well performing investments and neglect investments that are not going to generate carried interest. The excessive use of leverage by certain managers acted to significantly increase the volume of those mistakes. Saddled with the use of leverage, these managers were unable to weather the storm of decreasing property income relative to the debt service required by high loan-to-value (LTV) loans and found themselves unable to refinance their loans at maturity. In some respects, the crisis illuminated which managers have adopted a more consistent investing approach and this was reflected in their performance. With the survival of the fittest, investors have differentiated track records to evaluate which fund managers best suit their criteria.

## Alternatives to the Fund Model

After the global financial crisis, a number of commentators asked whether there were better models than the private equity real estate fund model. In particular, the club format received significant attention due to the ability of investors to assert a greater degree of control over the club’s strategy and investments. Another argument for the club model is that investors are able to choose their fellow investors and, therefore, ensure common alignment amongst them. While this may be true at the onset of an investment, this is no guarantee that over time the club participants’ interests and strategies do not diverge. Once a divergence occurs, it can be very difficult to obtain consensus over capital expenditures, asset management strategies, and exit timing and strategy. This can lead to paralysis and a sub-optimal outcome for all participants. With the more complex asset management and operationally intensive strategies common to higher yielding real estate such as value-add and opportunistic investing, the private equity fund model can be more advantageous because it provides top performing fund managers with greater control and flexibility in the decision-making process and ultimate exit strategy and timing.

A hybrid solution to the club versus fund debate is the commitment of discretionary capital to a private equity real estate fund combined with co-investment vehicles for specific transactions. Co-investment vehicles have become particularly useful in the current environment given the continued scarcity of debt, the consequent need by fund managers to use greater amounts of equity and the difficulty and time taken to raise capital with investors. The co-investment vehicle approach can combine the best features of the private equity real estate fund model with the club format. The structure offers investors the advantage of being able to upsize allocations to certain investments that are particularly compelling and where more concentration is warranted. In addition, fee structures for co-investment sidecar vehicles are also typically lower than standard fund fees allowing investors the ability to average down the overall expense of the fund. Investors who want to take advantage of these co-investment vehicles must have the bandwidth and sufficiently flexible corporate governance to consider these opportunities in the time frame required.

## Conclusion

In summary, the private equity real estate fund format has many advantages including attracting the most successful real estate investors. Amongst those managers, limited partner investors can make commitments to top-performing funds that have demonstrated a consistent investing approach, discipline, and alignment of interest with investors. A direct approach where limited partner investors maintain a higher degree of control and discretion can make sense for larger investors in certain situations but the private equity real estate fund model favors the skill

and experience required in more value-add and opportunistic investing. Lastly, co-investment sidecar vehicles can offer advantages of both approaches to large, sophisticated investors who have the ability to evaluate real estate risk and may want to take on more exposure to particularly compelling transactions, or a specific asset class, geographic market, or investment strategy.

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Risks Related to Investments in Real Estate and Real Estate Related Securities. A portfolio of private equity real estate funds (a "Portfolio") will invest in underlying funds ("Underlying Funds") that invest in office, apartment, industrial, and other commercial real estate properties located primarily in the United States, as well as in real estate related securities. Accordingly, the investments of the Underlying Funds will be subject to the risks incident to ownership and development of real estate, including risks associated with changes in the general economic climate, changes in the overall real estate market, local real estate conditions, the financial condition of tenants, buyers and sellers of properties, supply of or demand for competing properties in an area, accelerated construction activity, technological innovations that dramatically alter space requirements, the availability of financing, changes in interest rates, competition based on rental rates, energy and supply shortages, various uninsured and uninsurable risks (including possible terrorist activity), and government regulations.

Further, the real properties underlying the investments of the Underlying Funds will be subject to federal and state environmental laws, regulations, and administrative rulings which, among other things, establish standards for the treatment, storage and disposal of solid and hazardous waste. Real property owners are subject to federal and state environmental laws which impose joint and several liability on past and present owners and users of real property for hazardous substance remediation and removal costs. In addition, investments in assurance real estate or interests in real estate are illiquid and subject to industry cycles, downturns in demand, market disruptions and the lack of available capital from potential lenders or investors. Accordingly, there can be no assurance that the manager of an Underlying Fund will be able to dispose of its investments in a timely manner and/or on favorable terms. Furthermore, there can be no guarantee that there will be tenants or purchasers for the office or commercial space or residential units ultimately developed. Some Underlying Funds may employ leverage in connection with their operations and investments. Such leverage may be recourse to such Underlying Funds. The use of leverage involves a high degree of financial risk and may increase the exposure of the Underlying Funds or their investments to factors such as rising interest rates, downturns in the economy or deterioration in the condition of the properties underlying such investments.

Real estate development and repositioning is a highly competitive business which involves significant risks. In particular, because of the long lead-time between the inception of a project and its completion, a well-conceived project may, as a result of changes in real estate market, economic and other conditions prior to its completion (including as a result of the construction of competing projects), become an economically unattractive investment. It is possible that an Underlying Fund may make a commitment prior to obtaining all necessary entitlements, approvals or consents and may not obtain or may incur significant costs to obtain such items. In addition, real estate development involves the risk that construction may not be completed within budget or on schedule because of cost overruns, unforeseen construction difficulties, work stoppages, shortages of building materials, the inability of contractors to perform their obligations under construction contracts, defects in plans and specifications, failure to obtain necessary entitlements or other factors. Any delay in completing a project may result in increased interest and construction cost, the potential loss of purchasers or tenants, increased competition from other projects, and the possibility of defaults under project financings. In addition, the demand for quality commercial real estate projects is largely dependent upon the continued economic growth of the markets and submarkets in which these projects are located. There can be no assurance that such economic growth or demand for such projects will continue in the markets in which the Underlying Funds make their investments or that the actual occupancy and/or rental rates for the real property underlying the Underlying Funds' investments will not be less than the projected occupancy and/or rental rates used in determining whether to make such investments. Furthermore, increased real estate development in such markets may lead to periods of oversupply and result in vacancies, lower rentals, and lower sale prices for real estate projects.

Investments in real estate related securities involve many of the risks associated with real estate investments as described above, as well as additional risks, including, but not limited to, interest rate and credit risk, lack of liquidity, risk of principal prepayment, risk of loss of principal, and risk of default.

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