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Waiting for the tide to come in

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Partners Group
Passion for Private Markets

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The real estate markets in developed countries appear to be at an inflection point. One asks has the hemorrhaging finally stopped? Are we languishing in the doldrums? Or has the tide actually turned and will capital flow back into the sector? There is considerable speculation as to the directional movement of the real estate markets. What is the market telling us? As we look forward to the next 12 to 18 months, Partners Group has a strong conviction that the tide not only is coming in, it is coming in far faster than many believe.

- Partners Group believes substantial capital that has been sitting on the sidelines will flow into what is perceived to be the least risky sector of real estate – trophy, core properties.
- Capital, not fundamentals, will bolster prices in the core, trophy sector. Investors will mistake this for a recovery across the asset class.
- Consequently, core real estate assets may actually be riskier than the market perceives due to the abundance of capital.
- Partners Group's view is that investors should target those opportunities where capital is most constrained to obtain the highest risk adjusted returns.

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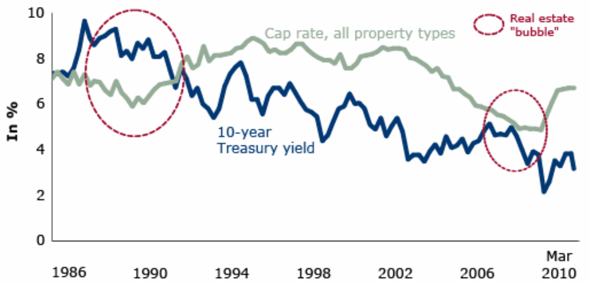
HOW SHOULD INVESTORS REACT?

So the salient questions are: Where will new capital invest in real estate? What kind of real estate should one buy? What are the opportunities? Where can the savvy investor find the best risk adjusted returns? At Partners Group, we think the "herd" mentality will cause many investors to invest in core, "trophy" properties. Our view is that more sophisticated investors will search for those opportunities which remain capital constrained including investments in secondaries, debt recapitalizations and emerging markets real estate.

What can we learn from history? The return pattern for the United States, as depicted in Exhibit 1, left side, suggests the following.[1] First, over time, cap rates have various spreads, both positive and negative, relative to the local risk free rate of return based upon the market's perception of risk. When the appetite for real estate has aspects of "irrational exuberance" as evidenced in the late 1980's and again in 2007, real estate "bubbles" emerge.

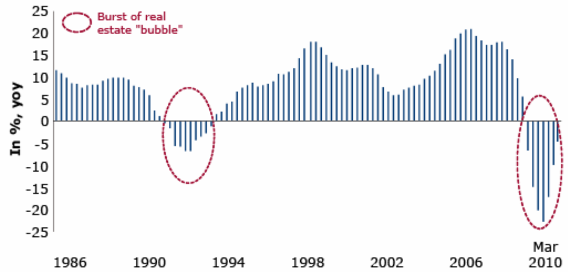
Exhibit 1: When Real Estate "Bubbles" and Rebounds Occur

US core real estate cap rates vs. 10-year Treasury yield



Source: Bloomberg, Partners Group, June 2010

Total US core real estate returns



Source: Bloomberg, Partners Group, June 2010

But, as seen in Exhibit 1, right side, an inevitable collapse of prices follows when the bubble bursts. In both instances the market mispriced risk. In the late 1980's and in 2007 there was no perception of risk and the cap rate spread over the risk free rate evaporated. By the early 1990's and 2008, the pendulum swung in the opposite direction and the market's perception of risk exploded. The capital tide moved out even more quickly than it had come in.

We think the more interesting issue is the market's reaction after the bubbles burst and the market correction occurs. Periods of wide cap rate spreads relative to the risk free rate are followed by strong total returns in the asset class. The spreads today are as wide as they have ever been historically. The market is clearly telling us that the potential exists for strong prospective performance in the asset class.

This data, though, is not uniquely available to Partners Group. Many investors have analyzed this information and have concluded that 2010 and 2011 may be an opportune time to consider real estate. By some estimates there is over $180 billion of "dry powder" waiting to be deployed after "window shopping" for the past three years. By our estimates, this number is understated as the amounts attributable to the Sovereign Wealth funds are difficult to calculate. Is there a tsunami wave of capital coming?

[1] We use the US market as an example due to the duration of the time series. However, Partners Group believes it is reflective of the Western, developed markets.

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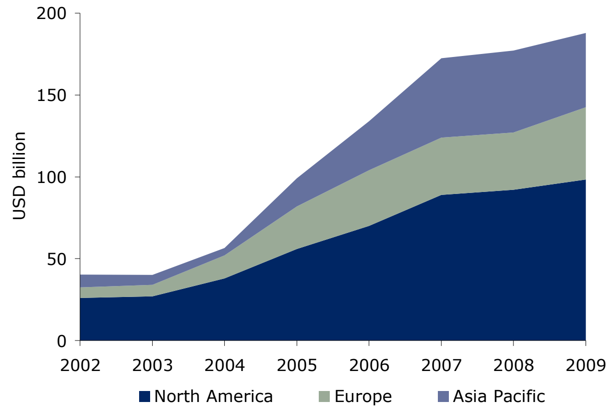
Exhibit 2: Dry Powder of private real estate funds by region over time



Source: Preqin (May 2010)

What will these new investors buy and when? Our strong belief is the vast preponderance of this capital will target "core", trophy assets. Human nature, being what it is, will lead those investors who have been burned in the last downturn to reenter the asset class in what they perceive to be the least risky investment alternative. There will be a flight to perceived quality.

The consensus view is that these core assets will be attractively priced[2]. We disagree. If any investor can acquire a fully leased, well located core property in London, Paris, New York or any other major 24/7 city at a 7% or 8% cap rate, they should buy it immediately. We simply don't believe that is possible today, as it is our view that the market has already moved; the reported numbers as shown in Exhibit 3 have not yet caught up with the market.[3]

[2] Market Outlook, Trends in the Real Estate Private Equity Industry, Ernst & Young, 2010. In this White Paper, the firm surveyed 100 real estate professionals. Sixty–seven percent of those surveyed indicated the weakening real estate fundamentals will continue to put downward pressure on privately held real estate values making overall prices attractive.

[3] The possible exception to this is to purchase units in open-ended core funds whose appraisals have not yet caught up with the market. But even this arbitrage window is closing as many of the better performing funds now have entry gates, as opposed to the redemption queues, that existed only six months ago.

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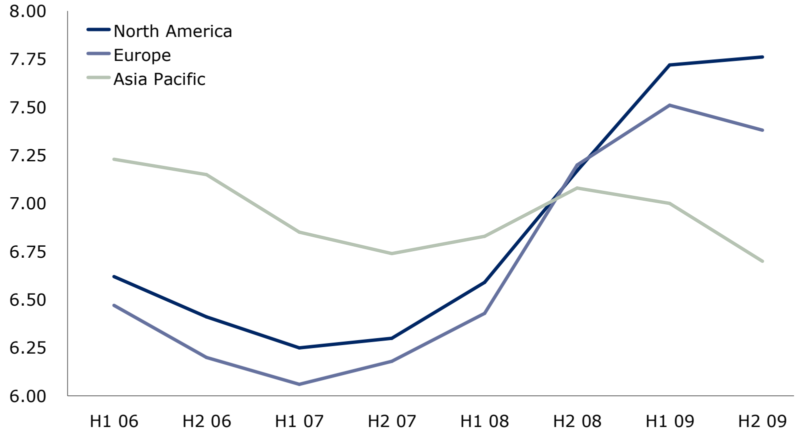
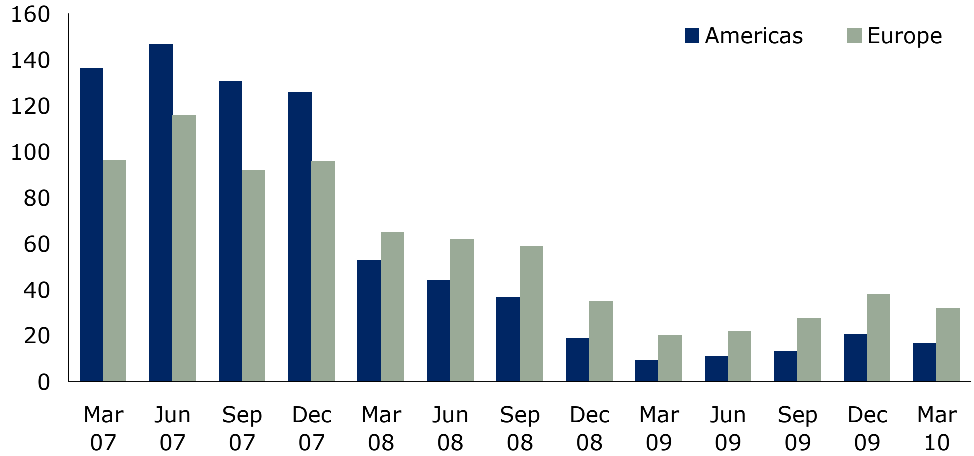
Exhibit 3: Global commercial real estate all property cap rates by region in %



Source: Preqin Real Capital Analytics, Cushman Wakefield (March 2010)

There is very little to buy today, as evidenced by Exhibit 4. Indeed, the transaction volume in the United States has evaporated. The lack of quality supply coupled with available capital will most certainly have an impact on the pricing of core assets when they come back on the market.

Exhibit 4: Global commercial real estate transaction volumes in USD billion



Source: Real Capital Analytics (May 2010)

The demand for core assets is somewhat surprising given the relatively weak forward looking real estate fundamentals. GDP estimates are somewhat positive, but clearly risk exists on the downside as the drivers of an economic recovery in the developed markets of North America and Europe remain weak.

The largest risk factor for real estate remains the persistently high unemployment rate. Job growth is anemic, at best, in most of the developed markets.

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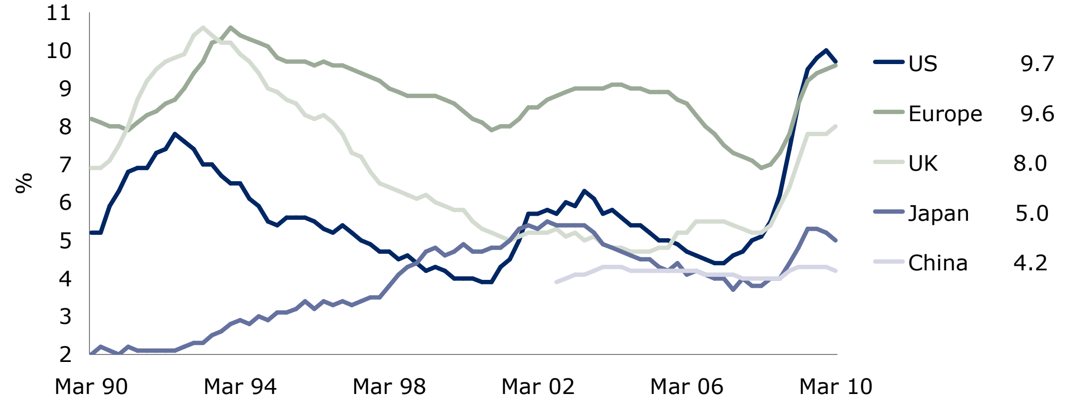
Exhibit 5: Unemployment by country/region



Source: Bloomberg (28 May 2010)

Tracking unemployment rates is important because of its very positive correlation with vacancy rates. This relationship persists in cities around the globe.

Exhibit 6: Unemployment vs. office vacancy rates

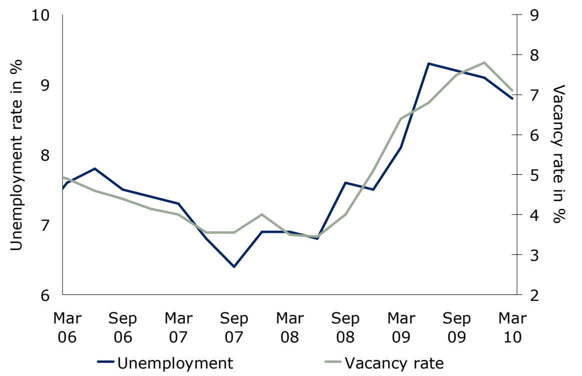
West US

Source: Bloomberg (July 2010)

East US

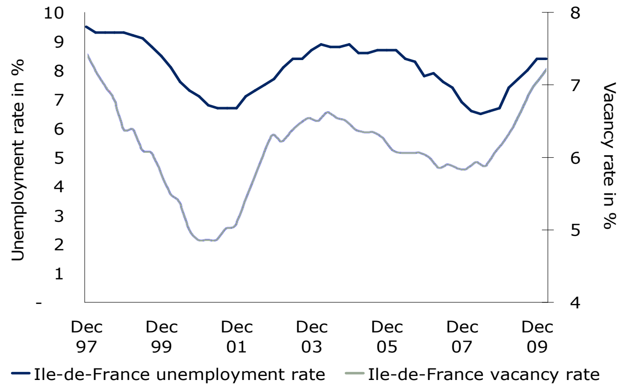
Source: Bloomberg (July 2010)

London



Source: Bloomberg, CBRE (March 2010)

Paris



Source: Bloomberg, CBRE (December 2009)

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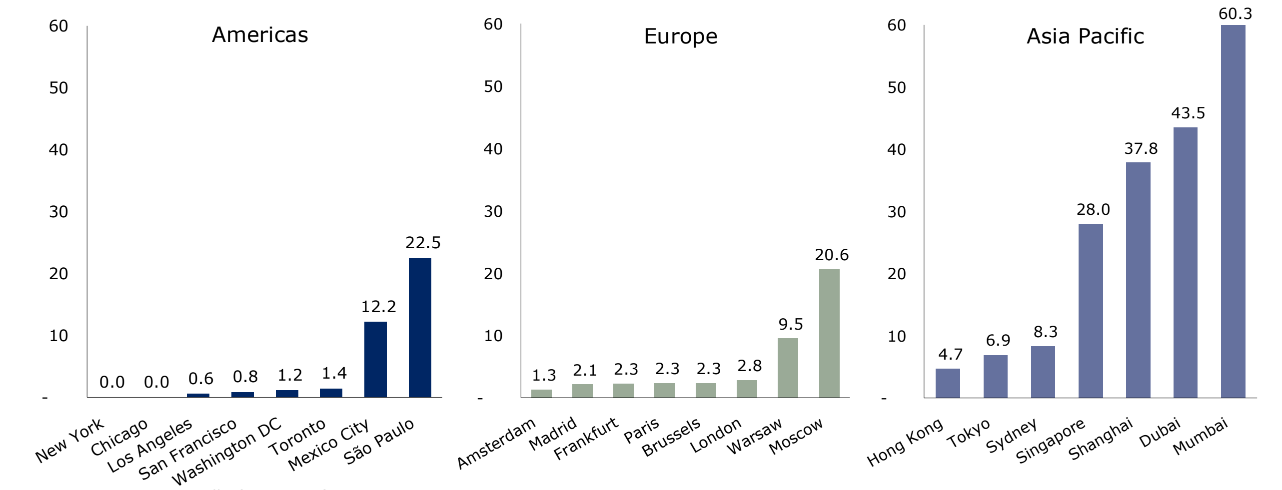
And, clearly vacancy rates have an impact on rental growth as reflected in the charts in Exhibit 7 below. Vacancies are anticipated to increase in 2010 and consequently rents are forecasted to contract throughout the remainder of this year and into 2011. So, Partners Group expects real estate fundamentals to decline before they improve due to overall weak demand for space.

The only bright spot in the market fundamentals is the lack of new supply. The supply pipeline, especially in the United States and Canada, is astonishingly low. It is also quite low in Western Europe. This suggests that when demand for space increases, we could see a very sharp rise in rental rates, and thus property price increases. It would likely be more of a "V shaped" recovery in prices for real estate.

Exhibit 7: Grade A office supply pipeline 2010-2011 as percentage of Q1 2010 stock



Source: Jones Lang LaSalle (May 2010)

So, how does an environment in which we anticipate worsening fundamentals square with our view that core, trophy asset prices will increase? We think that the wave of capital will result in numerous bidders initially on a small number of transactions. This will cause cap rates to fall below the 7% to 8% range reflected in older appraisals. We expect to see articles "heralding" the return of real estate.

One must focus on the cap rate spread over the risk free rate and given the current low interest rate environment, lower cap rates may be justified. Lower initial returns for core properties in the 5.5% to 7.0% range, unleveraged, will be the norm. But given this return spread for real estate over other investment alternatives, some investors will feel justified. However, we question whether this is the optimal investment strategy to generate the highest risk-adjusted returns.

What will appear to be a recovery in the core property markets will mask the real distress that continues to exist in many segments of the market. A significant number of assets are in foreclosure. It is still difficult for property owners with mortgages coming due to refinance assets that are leased and cash flowing.

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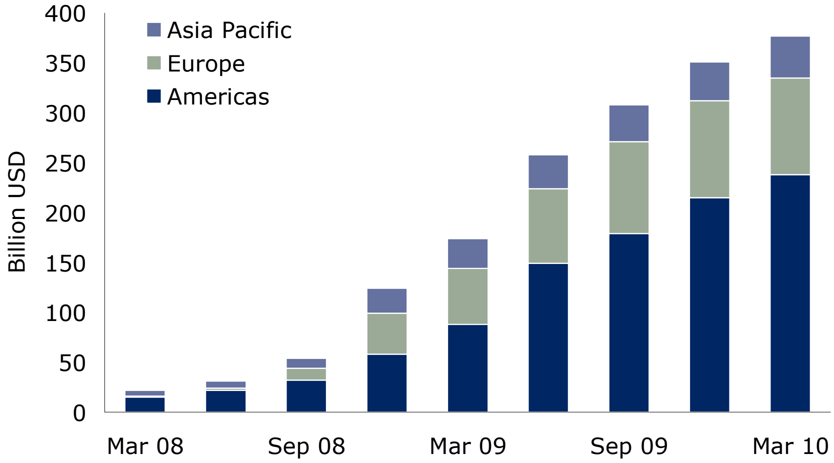
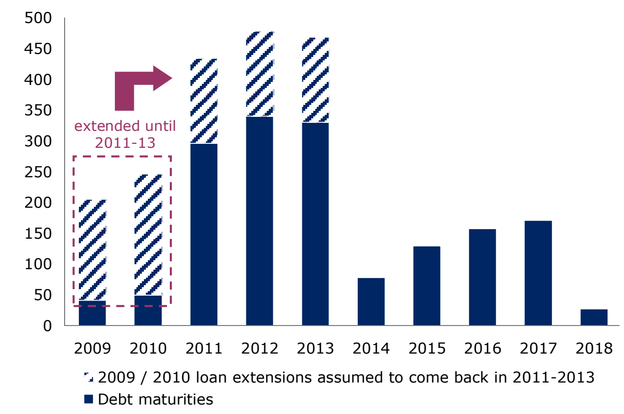
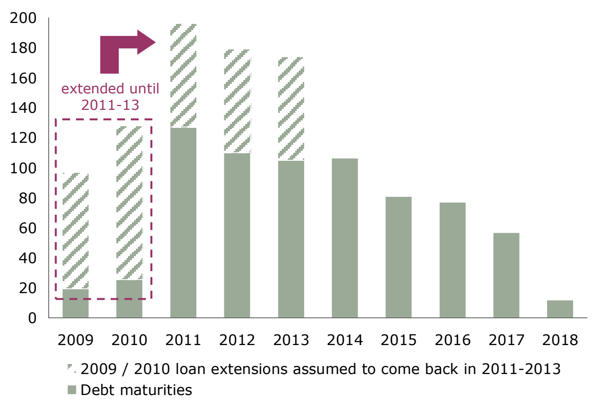
Exhibit 8: Distressed[4] real estate debt by region in USD billion



Source: Jones Lang LaSalle (May 2010)

Exhibit 9: Estimated total commercial real estate debt maturity schedules by region





Source: Partners Group computations, RREEF (June 2010)

As banks try to extend these loans they typically require equity infusions to amortize principal. Loan-to-value ratios (at today's values) for first mortgages have been substantially reduced by lenders necessitating incremental capital to originate a new loan.

Partners Group intends to assist those borrowers with "good assets but bad balance sheets" in the deleveraging of those investments. We seek opportunities in assets or portfolios in which the properties are leased and cash flowing. The borrower requires capital to reduce the loan-to-value ratio to meet new lending requirements. Our capital invests senior to the equity and receives mid to upper teen returns for being in the 65% to 79% range of the capital stack. These opportunities are plentiful and the competitive landscape for these investments is quite favorable.

[4] Distressed assets are defined as assets in foreclosure, bankruptcy, Real Estate Owned assets, as well as properties where ownership or debt terms have changed, but a long term resolution of the cause of the distress has not been reached.

CONCLUSIONS

Our view is that better investment alternatives exist in those areas of real estate that remain cash constrained. Notwithstanding the capital available for trophy assets, little is presently available for distressed situations. Ironically, when the market had no perception of risk, capital was abundant for "opportunistic" real estate investments. Today, the situation is exactly the reverse.

Capital is very dear for any real estate investment strategy outside of the core space. But, today one actually gets paid for assuming some risk. We ask whether it is more or less risky to buy a core property in a frothy environment and accepting a lower return, while being at the bottom of the capital stack, versus investing higher in the capital stack of the real estate transaction and receiving more than two times the return for the investment? Partners Group believes core investments in 2010 and 2011 are deceptively more risky than many investors assume due to the abundance of capital in that market segment.

In short, our view is that the case for buying direct, core equity real estate in the United States and most of Western Europe for mid single digit, unleveraged returns is not compelling. A better investment strategy is to obtain the equity exposure in the secondary market at a discount to NAV. Buying interests at a discount in existing properties with leased, core assets will provide substantial premium returns to buying the assets directly.

Savvy investors will seek out opportunities in cash constrained market segments. Participating in the inevitable deleveraging that simply must occur will generate very attractive risk adjusted returns at this stage of the market cycle.

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