The real estate secondary market: enhanced returns with lower risk

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Partners Group
Passion for Private Markets

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EXECUTIVE SUMMARY

Real estate secondary transactions represent the purchase of interests in property portfolios and/or single assets from existing investors. These transactions are often consummated at a discount to the net asset value (NAV) of these assets and therefore provide investors with some unique advantages. Whereas a typical real estate portfolio owns ten or more assets, a real estate secondary investment strategy generally provides investors with broader diversification from owning hundreds of assets. Given that you are buying in at a later stage, investors will have less duration risk as capital and profits will be returned sooner than if they were invested in a blind pool at inception. Furthermore, in contrast to a blind pool investment program, buying into an existing portfolio allows the investor to substantially mitigate the risk of a J-curve. To the extent you can buy into non-core real estate assets that are four to five years into their typical ten-year life, your entry is at a point in time when a substantial portion of the value creation is largely complete and where the assets therefore possess more core-like attributes. By acquiring such assets at a discount to NAV, you can often generate significant cash-on-cash returns to your equity and a return profile more akin to a value-added strategy, but with core-like property risk.

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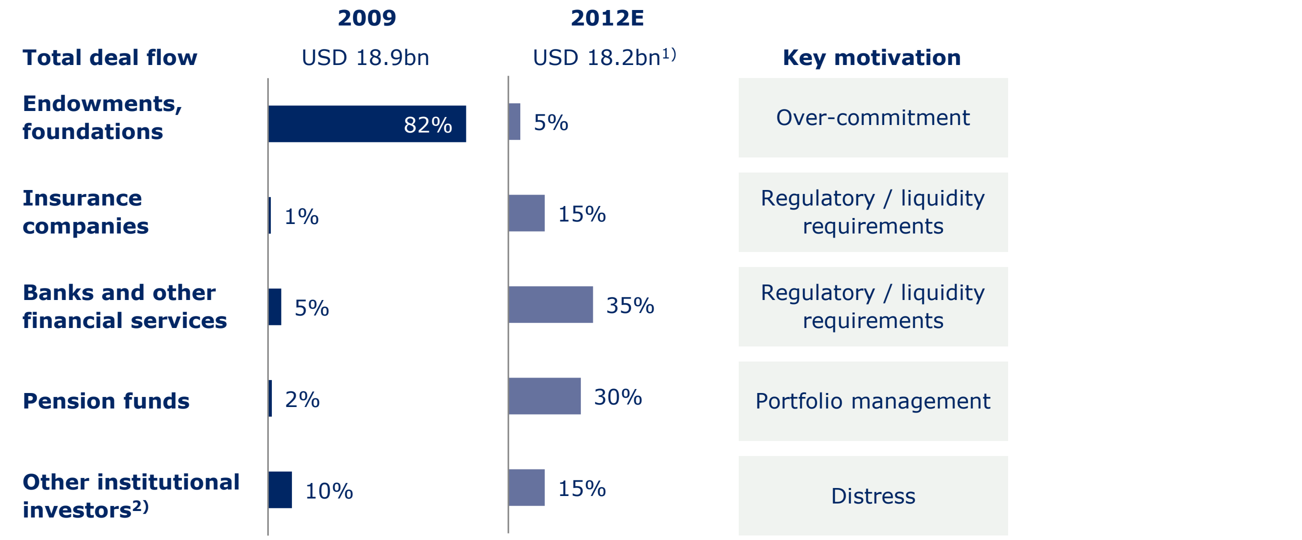
INSTITUTIONAL INVESTORS' MOTIVATIONS VARY ACROSS CYCLES

To have a vibrant real estate secondary market, one needs motivated sellers. Absent distress or other factors, seller motivation is inversely correlated to the required discount to NAV from a buyer. As depicted below, the nature of the sellers and their motivations continue to evolve over time and, despite the lack of investor distress in the current market environment, there are many other motivating factors that have steered investors towards the real estate secondary market to seek early exits.

Exhibit 1: Shifting sellers and motivations, 2009 vs. 2012



Source: Partners Group deal flow
[1] Annualized 30 September 2012 YTD deal flow of USD 13.6bn
[2] Includes individuals, family offices, funds of funds, hedge funds, etc.

Immediately after the financial crisis, endowments and foundations following the so-called "Yale Model" of placing a disproportionate bet on alternative investments were the most acutely distressed. Many of these organizations depended upon the profits from their investments to fund their operating budgets and were therefore faced with an immediate cash squeeze. Furthermore, many of these organizations had very large outstanding obligations from past commitments and, if such obligations were fully funded, it would have further exacerbated their portfolio concentration to alternatives. In contrast, the market today has a much deeper pool of sellers, albeit, as described below, with different drivers.

NEAR-TERM MARKET DRIVERS

While over-commitment and investor distress clearly served as the initial catalyst to institutionalize the market opportunity and promote industry awareness at the onset of the recent recession in 2008-2009, ongoing shifts in portfolio management and regulatory pressures on financial institutions are not only the primary drivers of deal flow in the current environment, but are also expected to drive future deal flow.

Shifts in portfolio management. For better or worse, many public pension plans have reacted to recent market volatility by migrating capital to core investments, and selling non-core investments in an attempt to de-risk their portfolios. While we believe that there can be greater risk in acquiring core assets at low capitalization rates than in investing in select non-core assets in the current market environment, we are pleased that this trend will stimulate secondary deal flow. In addition, investors' market-specific concerns, such as overheating in parts of China or the euro potentially breaking apart, have caused them to selectively sell positions and rebalance their portfolios. We were recently approached by a large institutional investor wanting to sell all of their real estate exposure in a developed Asian country due to their views on its macroeconomic outlook. The investment opportunity is comprised of several positions with an aggregate potential transaction value of about USD 500 million.

In addition, many investors now recognize the opportunity cost of being saddled with legacy assets or commitments to managers with whom they do not plan to invest in the future. Combined with investor fatigue for assets of poorly performing vintage years (and their slow pace of distributions), this has led some to pursue large-scale liquidations. Such situations are often unattractive unless you can "cherry-pick" those assets or portfolios with the best likelihood of recovering unrealized losses. The key to successful "cherry-picking" is knowing the assets and understanding the property markets to identify investable inflection points. Shortly after the financial crisis, Partners Group engaged with a distressed European investor with a global portfolio of over 30 investments. Rather than offering the 75% discount to NAV necessary for the whole portfolio, which likely would have been rejected, we first transacted on several sub-portfolios of conservatively leveraged US and European assets that were poised to recover quickly. We subsequently executed two further transactions with the seller, each time "cherry-picking" what was most likely to recover in the near term.

Regulatory pressures on financial institutions increase. In addition to the steady increase in investment opportunities arising from portfolio management activities, there is an additional large driver of deal flow that will continue to play out over the next several years. Regulatory pressures on insurance companies and banks (Solvency II[1] and Basel III[2] in Europe as well as the Volcker Rule[3] in the US) have and will continue to pressure these financial institutions to shed private market investments. While certain institutions have been more proactive in selling off private market investments than others, thereby providing a significant source of secondary opportunities over the past year, the implementation of these reforms will happen over the next several years as regulators do not want to create another banking crisis. US institutions will have at least until July 2014 to fully comply with the Volcker Rule and final rules for Basel III are currently scheduled to go into effect between 2015 and 2018. This bodes well for the further evolutionary development of the real estate secondary market as there is no way that all of their holdings could be digested by the market within a short time frame. Fortunately, Partners Group is well-positioned for two fundamental reasons. First, Partners Group has a history of transacting with such organizations on their private equity holdings, so we can leverage existing relationships to transact with them on their real estate positions in the future. Secondly, as discussed later, there is very little dedicated capital raised to pursue the opportunity and, as a consequence, Partners Group is the one of the only organizations prepared to acquire large investments or large global portfolios.

Pockets of distress still remain. While institutional investors will never admit to being distressed, the longer investors avoid dealing with problems of excessive leverage, poorly

[1] Solvency II introduces equity requirements for insurance companies and is predicted to have a negative impact on their ability to continue to allocate equity capital to real estate as they have done in the past. As a consequence, they will likely shift from equity investments in real estate to debt investments in real estate.
[2] Basel III requires banks to increase solvency ratios while applying risk weightings to assets. Real estate has a high risk weighting, so reducing exposure will have a disproportionately favorable impact to capital ratios.
[3] The Volcker Rule is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. It dictates that banks' exposure to alternatives, real estate included, must be no more than 3% of their Tier 1 capital, and that banks cannot own more than 3% of any private equity, private equity real estate or hedge fund or firm.

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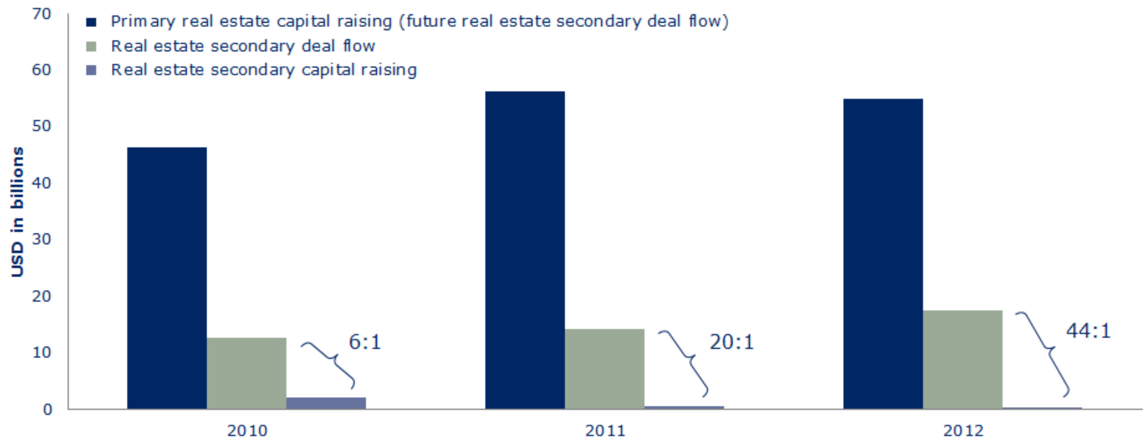
timed investments or regulatory pressures, the more likely they are to become distressed in the future. In particular, we have observed many family offices and foundations still struggling with legacy investments that have strained their financial resources and the opportunity cost of being saddled with them is rising daily. While some hope to recover values, many no longer have the choice to do so and must use the secondary market to create liquidity. Once again, the key is to "cherry-pick" those opportunities that alleviate seller distress but also provide Partners Group's clients with attractive risk-adjusted returns.

A SUSTAINABLE MARKET WITH LIMITED COMPETITION

The activities of the past few years have served as a catalyst to institutionalize the use of the real estate secondary market by institutional investors, mirroring the development of the private equity secondary market 10-15 years ago. The market should prove sustainable as primary fundraising is increasing again and will likely stabilize in the near term at approximately USD 60-70 billion per year. Assuming that 3-5% of capital raised will be offered for sale in the secondary market (similar to historical patterns that we have observed for the private equity industry), post-financial crisis capital raising activity should result in roughly USD 10 billion of real estate secondary opportunities per year. Over time, the real estate secondary market is expected to continue to become an acceptable transaction medium for more and more investors, thereby making the market opportunity even more sustainable.

At present, there are just a handful of players worldwide that have dedicated resources for real estate secondary investing and Partners Group remains the only truly global player among them. Since the financial crisis, there has been an aggregate of USD 3.3 billion of capital raised[4] to pursue the opportunity which stands in contrast to the more than USD 60 billion of deals sourced by Partners Group over the same time frame. This has led to a huge disparity between supply and demand, which has clearly swung the pendulum of negotiating power to the side of the buyer. As a consequence, our biggest barrier to securing a transaction is not competition from other buyers but rather the reluctance of certain sellers to accept the prices at which we would be willing to transact. In some cases, structured solutions can be used as a means to bridge a gap in pricing expectations. Fortunately for our clients, sellers have limited options if they are motivated to sell.

Exhibit 2: Supply (deal flow) far exceeds demand (capital)



Source: Preqin for primary and secondary real estate capital raising; Partners Group for real estate secondary deal flow

[4] Preqin and Partners Group

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MORE PALATABLE DISCOUNTS DRIVE YEAR-OVER-YEAR GROWTH IN TRANSACTION VOLUME, THEREBY ENSURING A MORE VIBRANT REAL ESTATE SECONDARY MARKET

On the heels of the financial crisis, few transactions were consummated as the required discount to NAV for a buyer was quite high, often exceeding 50%, because the appraisal-based methodology used to derive NAV was backward-looking and pointed to comparable sales transactions that occurred at the peak of the market. In today's environment, where valuations are better grounded, the required discount to NAV has moderated for non-core real estate portfolios to a range of 10-25% of NAV, but could be higher or lower depending upon the facts and circumstances of a specific opportunity or asset. At that level, we have observed an upward spike in executed transactions and this favorable market momentum continues to this day. As a consequence, and contrary to popular belief based on the lack of apparent investor distress, secondary investment opportunities have proliferated and, as reflected in the chart below, the amount of transactions executed are still increasing year over year, albeit from very low levels.

Exhibit 3: Annual real estate secondaries trading volume

Source: Institutional Real Estate Newsline

To illustrate the significance of Partners Group's market involvement, approximately USD 2 billion of transaction value traded hands in 2011. That same year, Partners Group closed on approximately USD 600 million in transaction value. In fact, since the onset of the recent recession of 2008-2009, Partners Group closed on over USD 1.4 billion in transaction value.

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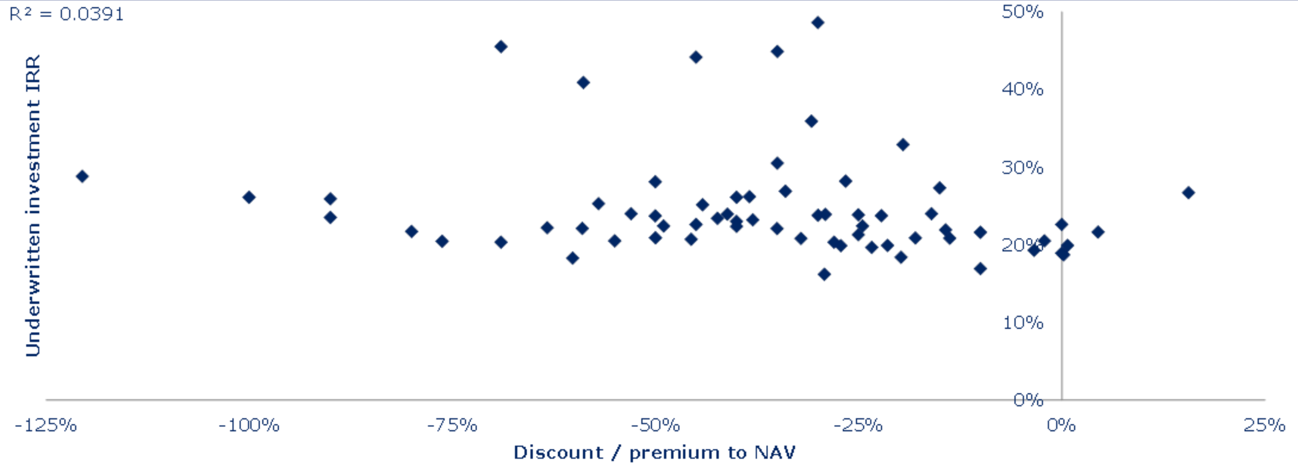
While "discount to NAV" is the most commonly quoted (and over-used) metric to describe pricing and valuation on secondaries, it is the price paid relative to the intrinsic value of the portfolio of real estate assets (and the ability to effectively execute business plans) that matters at the end of the day. As a consequence, there is no correlation between discounts to NAV and performance. The following chart provides an illustration of Partners Group's underwritten IRRs for past real estate secondary transactions at their various discounts/premiums to NAV.

Exhibit 4: Underwritten investment IRR versus discount/premium to NAV



For illustrative purposes only. Data is from real estate secondary transactions closed by PG through 30 September 2012. Discount/premiums presented after reversing pricing re-allocations that were necessary in transactions involving multiple interests

HIGH BARRIERS TO ENTRY

A question we are commonly asked is, "if the opportunity in real estate secondaries is so attractive, then why has the strategy not attracted more buyers with dedicated capital to exploit the opportunity?" The answer is that there are a number of natural barriers to entry specific to this strategy that prevents the majority of potential buyers from capitalizing on the opportunities with any type of scale.

Global presence with local real estate expertise. While sellers have been largely located in Western Europe and North America, their real estate holdings are very global in nature. While some investors only seek to sell a small handful of positions, others are looking for wholesale liquidations of assets that cover all geographic jurisdictions. As a consequence, having a global presence is increasingly important in order to capitalize on the information arbitrage when acquiring non-core real estate in regions of the world where an educated buyer can potentially access better data than the seller. At Partners Group, our global investment activities facilitate a feedback loop on a real-time basis to better understand how real estate is trading in various jurisdictions around the globe. In contrast, we have observed that other secondary buyers elect to focus on only those local opportunities that they can readily underwrite.

Additionally, close interaction with lenders locally allows a secondary investor to analyze the degree to which assets are readily financeable and under what terms. This is an extremely important consideration for a secondary buyer because if properties are not readily financeable then they will not likely be saleable, thereby influencing the amount and timing of future distributions to a secondary buyer.

In one recent transaction, Partners Group proposed a tender offer to investors in a pan-European industrial portfolio that were either unwilling or unable to go along with a proposal for a multi-year extension of the investment program. For Partners Group, this represented an opportunity to buy into a stabilized portfolio of well-leased industrial assets at a time when our research indicated that capitalization rates were at a cyclical high, rents were starting to rise and occupancies were starting to improve. This transaction could only be accomplished if the portfolio's underlying debt could be extended for five years so we worked closely with the sponsor to secure such extension, thereby making the overall transaction feasible.

Market and data intelligence. Buyers are often faced with the challenge of trying to determine an appropriate price for a portfolio of assets with very limited publicly available information or nothing more than a capital account statement or a quarterly report. While there are multiple sources of data to help a buyer assess the characteristics of the real estate, the ultimate value will be dependent upon the ability to execute the business plan of the asset and that, in turn, is dependent upon having a capital structure that will provide appropriate financial flexibility. Near-term debt maturities, debt that is cross-collateralized or cross-defaulted, or recourse debt can be a material impediment to the ability to execute the business plan. Unfortunately, quarterly reports often omit such critical information or provide for very limited disclosures, thereby making it difficult for a buyer to form an opinion of value. As a consequence, a buyer must either have prior intimate knowledge of the investment, have extensive experience in the respective field or be able to rely on a large proprietary database to assess the given information. Partners Group's primary investment activity provides us with extensive knowledge on over 350 value-added and opportunistic real estate portfolios containing thousands of underlying assets which are closely tracked.

Private equity secondary specialists are not expected to enter the real estate market in the near term. To date, we have not seen the private equity secondary specialists actively enter the real estate secondary space. With the exceptions of the Carlyles, Apollos and Blackstones of the world, there are few global players that overlap between private equity and real estate, so many of the private equity secondary specialists lack the required intimate knowledge of the individual assets. Furthermore, few of them have the comprehensive understanding of real estate-specific valuation metrics, markets and players to sufficiently underwrite real estate portfolios. Lastly, the financing structures used for real estate holdings are often significantly more complex than those encountered in private equity and many private equity specialists are unfamiliar with these complexities. As a consequence, it remains unlikely that we will see them competing for investment opportunities in a meaningful manner in the near term.

ROBUST SOURCING INITIATIVES ARE CRUCIAL AND A KEY INGREDIENT FOR SUCCESS

It is a game of numbers. Sourcing and generating proprietary deal flow is the lifeblood of a successful secondary investment strategy. Secondary buyers need to develop and maintain a strong industry network with investment partners in order to generate proprietary opportunities. A global integrated sourcing effort across business lines and across asset classes offers significantly greater deal flow than secondary-only managers with a smaller headcount and limited geographic reach. This enables Partners Group to cast a wide net in order to weed out the motivated sellers from the "tourists" who are just looking for indications of pricing and would not likely sell unless a price was offered at very close to NAV. Overall, sourcing efforts at Partners Group resulted in the screening of over USD 60 billion in real estate secondary opportunities globally since the onset of the recent recession, more than half of which was sourced on a proprietary basis. During that same time frame, Partners Group transacted on over USD 1.4 billion of that total (or less than 5%) and the vast majority of the opportunities transacted upon were ones we sourced on a proprietary basis.

A global strategy requires a global presence. With over 150 professionals located in Europe, North America, Asia-Pacific and Latin America that have sourcing goals and proactively cover potential sellers across all geographies and types (e.g. pension funds, endowments, family offices, insurance companies, banks, high-net-worth individuals, etc.), we believe that Partners Group has one of the largest sourcing teams in the industry. Training and reporting of all secondary-related sourcing activity is centrally coordinated, with the result being that Partners Group's extensive network of relationships is used in a highly efficient manner. For example, a potential seller in Japan may prefer to communicate with a buyer based in his local market where the counterparty not only speaks the native language, but also understands specific cultural concerns and objectives. Thus, a local professional at a global firm can bridge ties through "on-the-ground" interaction with a seller and develop the situation in close cooperation with dedicated secondary professionals.

Offer creative solutions for the benefit of both the seller and buyer. Secondary buyers cannot rely on intermediaries for deal flow. To be a successful buyer, you must identify the seller's motivation in order to find the right angle to pursue and thus stay ahead of any competition. In particular, many sellers remain reluctant to record material losses, so a buyer's ability to creatively structure transactions can turn a mediocre opportunity into one with attractive risk-adjusted returns. For example, a buyer can structure a transaction such that they receive a preferred return and a seller's loss, if any, is deferred until the final liquidation of an investment program. For other sellers, a buyer's ability to offer a portfolio solution on a wide range of positions (sometimes reaching across the private market spectrum, including real estate, private equity, infrastructure, etc.) can be a key factor in the buyer's ability to negotiate a transaction on more favorable terms as, from a seller's perspective, a single purchase and sale agreement with a single buyer is a lot easier to negotiate than if dealing with multiple counterparties.

PROACTIVE LEGAL, TAX AND STRUCTURING EFFORTS OF POTENTIAL INVESTMENTS CAN MAKE ALL THE DIFFERENCE

Tax issues must be vetted early on. Because real estate is a hard asset it is easily and often taxed. Various jurisdictions around the globe tax income and gains from real estate and the transfer of title to real estate very differently, so it is extremely important to understand those tax ramifications up-front when formulating a view on pricing to be discussed with a seller. One cannot wait until a transaction is fully negotiated with a seller to start a legal review. Partners Group therefore employs an entire team of in-house legal and tax specialists fluent in the nuances of local real estate structures and taxation in order to minimize transaction costs and maximize after-tax returns to our clients. For example, to protect our clients, we insist that the seller be responsible for indemnifying our clients for all tax liabilities resulting from activities that predate our acquisition. While the likelihood of unforeseen negative tax rulings are remote, we have already had one instance where this provision has made all the difference between this investment performing on plan versus underperforming expectations.

Structuring can be used to enhance returns or minimize downside risk. Once an investment opportunity is identified and discussions with the seller have commenced, multiple issues may arise with respect to a seller's desires and objectives. Transactions may hit roadblocks, so deal development skills are therefore a critical ingredient to making a sound investment. When this occurs, an investment may go through multiple iterations before reaching its final form. In one illustrative transaction, Partners Group was faced with a situation whereby a large investor in a portfolio focused on the development of IT office parks in India defaulted on a capital call after having previously funded 63% of their capital commitment. The investor did not have the financial wherewithal to meet their unfunded obligation but also refused to sell their stake at a loss. Partners Group ultimately acquired the position by offering to assume the seller's unfunded obligation in exchange for a full cash sweep of all of the economics from the seller's stake until our clients received a 2.0x return on invested capital; residual capital would then be shared between our clients and the seller. In essence, so long as the office IT parks in India generated 0.7x, Partners Group's clients would earn 2.0x, thereby providing significant downside protection commensurate with accepting development risk.

Speed and ease of execution will trump pricing. Having in-house resources, with expertise in local markets, for structuring and executing transactions (as opposed to relying on external consultants, attorneys and advisors) allows a buyer to close transactions more efficiently, making the process quicker and less costly for the seller. This often translates to better pricing for the buyer and, in many cases, can make the difference between being able to negotiate terms on a first-look, proprietary basis versus having to compete for the investment opportunity in an auction. In one recent transaction, Partners Group was able to pre-empt an auction process and close a transaction despite not offering the highest price by agreeing with the seller to use the same purchase and sale agreement previously negotiated for a prior secondary transaction. In this situation, the transaction was very material in size, so the seller's only other alternative was to deal with a mosaic of buyers, each of whom would use their own legal counsel and seek to negotiate their own purchase and sale agreement, a costly and time-consuming endeavor for the seller.

PUTTING IT ALL TOGETHER – ASSET MANAGEMENT MEETS PORTFOLIO AND RISK MANAGEMENT

Secondary investing is best executed through a programmatic solution. While mature real estate portfolios reduce duration risk as they will likely liquidate in the near term, they are often characterized by high IRR's with multiples on invested capital that will usually be at the low end of the acceptable range for a secondary buyer. On the other hand, early stage real estate investments will have the potential for attractive multiple generation given their duration, but will have lower IRR potential (as well as requiring a thorough underwriting of the ability to effectively create value in these early investments). Another important consideration for portfolio and risk management is being cognizant of investment concentration risk. A properly diversified real estate secondary program will not only be appropriately diversified by vintage year but it should also be well-diversified by property type and geographic region in which the assets are located.

As a result, the ability of a buyer to effectively blend both early and late-stage real estate investments (with both vintage-year and geographic diversification) is key to generating attractive risk-adjusted returns for investors. At Partners Group, we have strict guidelines to prevent undue concentration risk.

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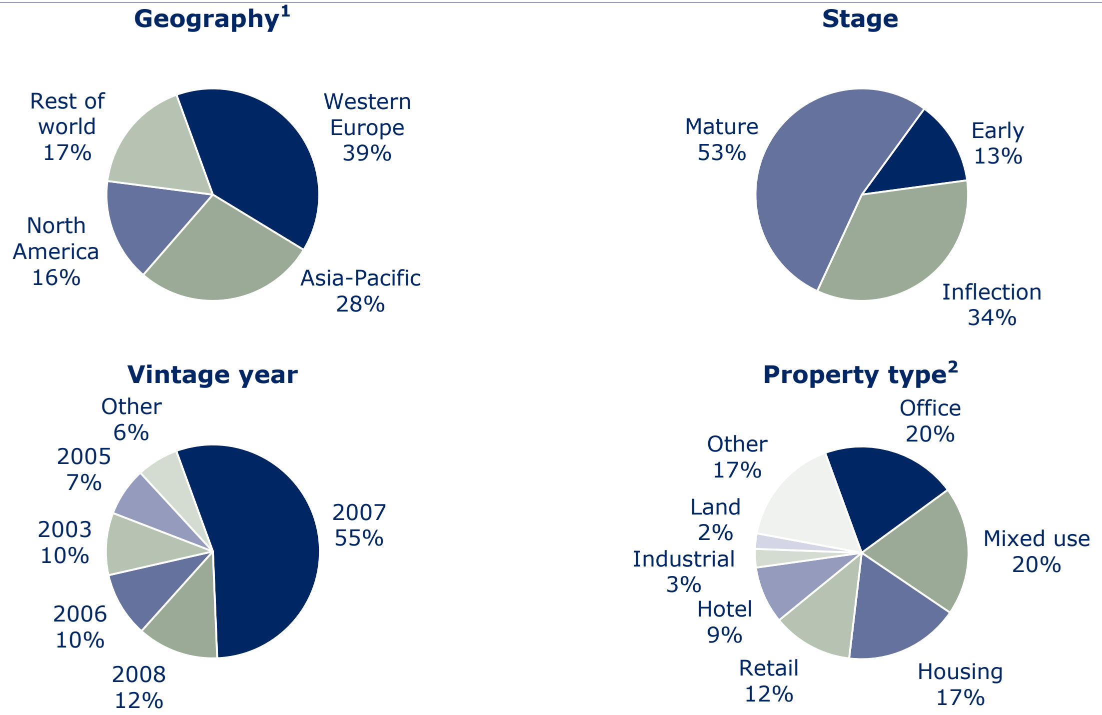
Our 2009-vintage year real estate secondary program has invested in over 40 portfolios possessing over 600 assets globally. The following pie charts illustrate the diversification by vintage year, stage, property type and geography for Partners Group's 2009-vintage year real estate secondary program.

Exhibit 5: Diversification of PG Real Estate Secondary 2009



Note: Based on all transactions completed by parallel investment vehicles of PG RE SEC 2009 through 30 September 2012. Breakdowns reflect adjusted commitments for all positions acquired, unless otherwise noted below.
[1]Allocations to each parallel vehicle may differ for structuring or tax reasons. Rest of world includes Central and Eastern Europe, Latin America and other emerging markets.
[2]Breakdowns reflect net asset value as of 30 September 2012 for all positions acquired and where such information is available.

BENEFITS TO THE INVESTOR

From the investor's perspective, investing in a real estate secondary strategy can yield a number of important benefits from a portfolio management perspective.

Eliminate the J-curve effect. Investors in secondary programs will often see early uplifts in value, which result from recapturing the discount to NAV (and more importantly the discount to intrinsic value) negotiated by the buyer. This, combined with the strong likelihood that investors will receive distributions from asset sales earlier as secondary investments are typically made three to five years into the life of the entire portfolio, should eliminate any J-curve effect. This is an important consideration for investors in commitment planning, many of whom have seen their investment timelines extended in recent years. At Partners Group, we help clients with customized solutions for investment activities as well as services such as portfolio planning, investment level steering and related treasury management activities to enhance their return expectations and lower their administrative complexity.

A de-risked and value-based strategy. By investing in a property during the later stages of its business plan, a secondary buyer can transact at a point in time when much of the development or repositioning risk has already been mitigated, thus altering the risk profile of a value-added or opportunistic strategy to one with more core-like characteristics. In addition, the ability to source and structure transactions offers the opportunity to create value "on the buy", reducing, though never eliminating, reliance on market fundamentals to drive returns. This is especially attractive today given the headwinds faced by most economies in the developed world.

Diversification. As transactions completed to invest a secondary program can involve portfolios with many in-place assets, investors quickly achieve far more diversification than if they were building a portfolio of a similar size themselves, on a primary basis. By way of example, Partners Group's most recent secondary program is invested in over 40 portfolios representing more than 600 assets. Similarly, geographical diversification can be readily achieved under a global investment focus so long as the secondary program is equipped to underwrite assets located around the world.

CONCLUSION

Partners Group believes that real estate secondaries will prove to be an attractive investment opportunity for the foreseeable future. Deal flow continues to be robust, driven by long-term market dynamics. The ongoing portfolio management activities of many public pension plans and increasing regulatory pressures on financial institutions create a sustainable supply of real estate secondary opportunities. Given the lack of experienced and knowledgeable buyers, this creates a compelling supply-demand gap. Since the financial crisis, there has been an aggregate of USD 3.3 billion of capital raised to pursue this investment thesis, which stands in contrast to the more than USD 60 billion of secondary investment opportunities sourced by Partners Group over the same time frame. As a consequence, and contrary to popular belief based on the lack of apparent investor distress, secondary investment opportunities have proliferated and the amount of transactions executed are still increasing year over year. While sellers have largely been located in Western Europe and North America, their real estate holdings are very global in nature and cover many geographic jurisdictions, thus, a global presence combined with in-depth real estate expertise and a comprehensive understanding of the local property markets is considered critical to successfully pursuing this strategy. Since the onset of the recent recession of 2008-2009, Partners Group closed on over USD 1.4 billion of transaction value across the globe and sees further potential in the future. However, real estate secondary investments do come with challenges: tax issues and structuring expertise to minimize downside risk need to be addressed early in the investment process as they can make all the difference for clients. Buyers of real estate secondaries who are able to navigate these challenges and have the necessary global due diligence capabilities can exploit the wide supply-demand gap in the market to achieve enhanced returns at lower risk.

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