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## Private real estate: why a global approach outperforms

Partners Group Research Flash May 2013



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Passion for Private Markets

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# Private real estate: why a global approach outperforms

## EXECUTIVE SUMMARY

While real estate investors have traditionally invested in domestic core properties, over the past few years we have observed a rapidly increasing trend in the market to gain exposure to real estate globally.

One driver is investors seeking better diversification in their real estate portfolios. They recognize that their domestic portfolios are typically highly correlated, and diversification across geographies can provide significant benefits. Furthermore, while Europe and the US continue to be the main source of real estate investment opportunities for institutional investors, demographic trends point to a shift in the balance of real estate opportunities towards Asia-Pacific that is already underway and which many investors are interested to exploit.

The second key driver is the attractive risk-adjusted returns that a global real estate investment strategy can deliver. An analysis of real estate returns from the Partners Group Thomson Reuters Private Real Estate Index provides evidence that investors can achieve long-term outperformance through a global approach. Given both the frequency and amplitude by which global portfolios have outperformed, this research flash aims to raise awareness of the increasing benefits of going global and demonstrate why a global approach should outperform “home-biased” or regionally focused portfolios.

Knowing the local nature of real estate as an asset class, it is also important to highlight how to invest in real estate globally, not only where. Unlike traditional asset classes such as listed equities or fixed income, real estate requires a specific approach and tools to successfully exploit the benefits of global properties. We conclude this research flash by sharing the experience that Partners Group has gained over the more than two decades its senior real estate team members have been active in real estate globally. Today, Partners Group’s approach to global private real estate is characterized by combining (i) a semi-annual top-down relative value assessment, with (ii) an integrated approach using direct, secondary and primary investments, (iii) a strong global deal flow allowing a high degree of selectivity, and (iv) significant local resources across our global platform.

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## INTRODUCTION

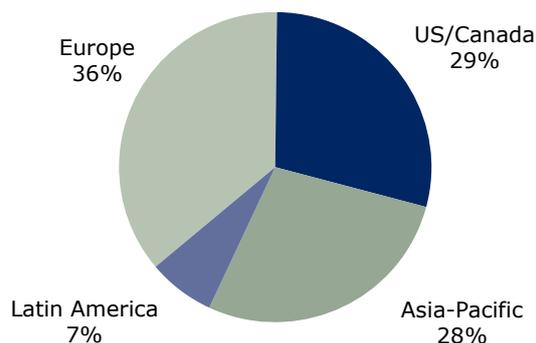
Since the nadir of the global financial crisis, property prices around the globe have rebounded sharply and investment activity has largely resumed close to where it left off; predominantly within sight of investors' backyards. In the following, we raise the question of why institutional investors are increasingly abandoning the "home-bias" in their real estate portfolios, and we evaluate the merits of employing a global approach.

In addition, we explore the risks and opportunity costs more traditional investors face by avoiding international markets in preference of investing exclusively in their home market. Given the total size and composition of the investable real estate universe, as well as the anticipated changes in the composition of global markets, there is a compelling argument to adopt a global approach to real estate investing. Real estate program performance also verifies that portfolios with the ability to invest across the globe using a relative value approach have delivered superior risk-adjusted returns when compared to "home-biased" portfolios.

## THE GLOBAL COMMERCIAL REAL ESTATE UNIVERSE

The global institutional-grade commercial real estate universe was recently estimated at a total size of USD 26.6 trillion, Europe being the largest real estate market by volume (USD 9.4 trillion) followed by the US/Canada (USD 7.5 trillion), Asia-Pacific (USD 7.2 trillion) and Latin America (USD 1.8 trillion).<sup>1</sup>

**Exhibit 1: Commercial real estate universe total volume by region**



Source: Prudential Real Estate Investors

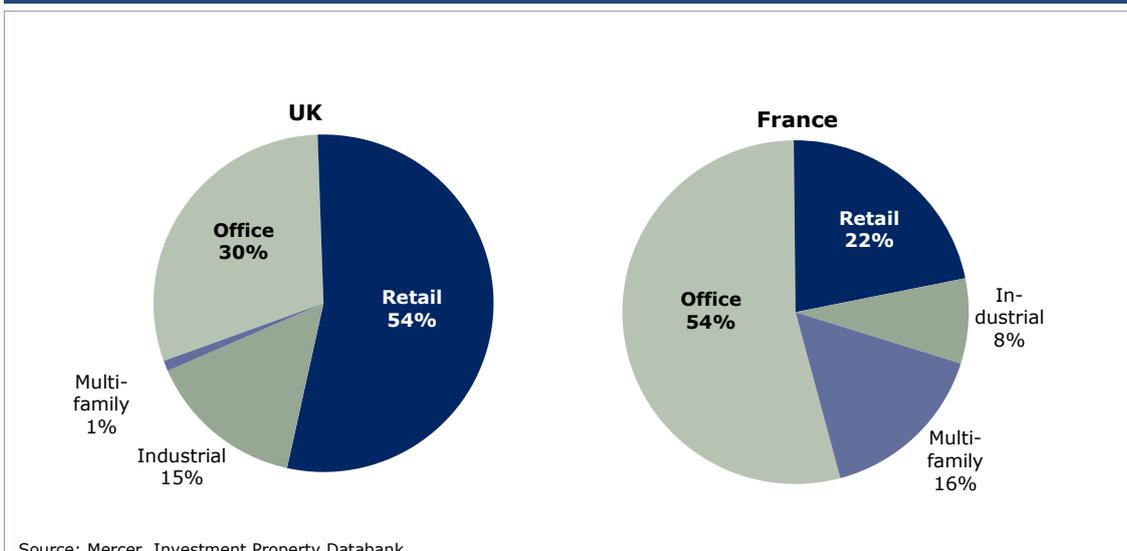
While seemingly fairly balanced by region, the investable universe is largely concentrated in a handful of key countries; primarily those with major metros that are characterized by a large

<sup>1</sup> Prudential Real Estate Investors. A Bird's Eye View of Global Real Estate Markets: 2012 Update, February 2012

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stock of commercial real estate with adequate liquidity. Over 50% of today's total commercial real estate market is represented by five countries: US (25%), Japan (10%), China (7%), Germany (6%) and the UK (5%).<sup>2</sup> In total, developed nations account for approximately 75% of all commercial real estate value. However, no two markets have an identical real estate market composition and even countries within the same region can differ dramatically. As an example, the largest real estate markets within Europe as of the beginning of 2012 were Germany, the UK and France. A natural assumption would be that these large mature markets of Europe have developed similarly over time and consist of a similar stock and property type, yet the composition of these markets stand in stark contrast, as shown in Exhibit 2. In this example, the UK's retail market comprises more than half of the total UK real estate universe, while in France the office sector is the dominant property type and retail is only 22% of the total institutional-grade universe.

**Exhibit 2: Real estate market composition by property type**



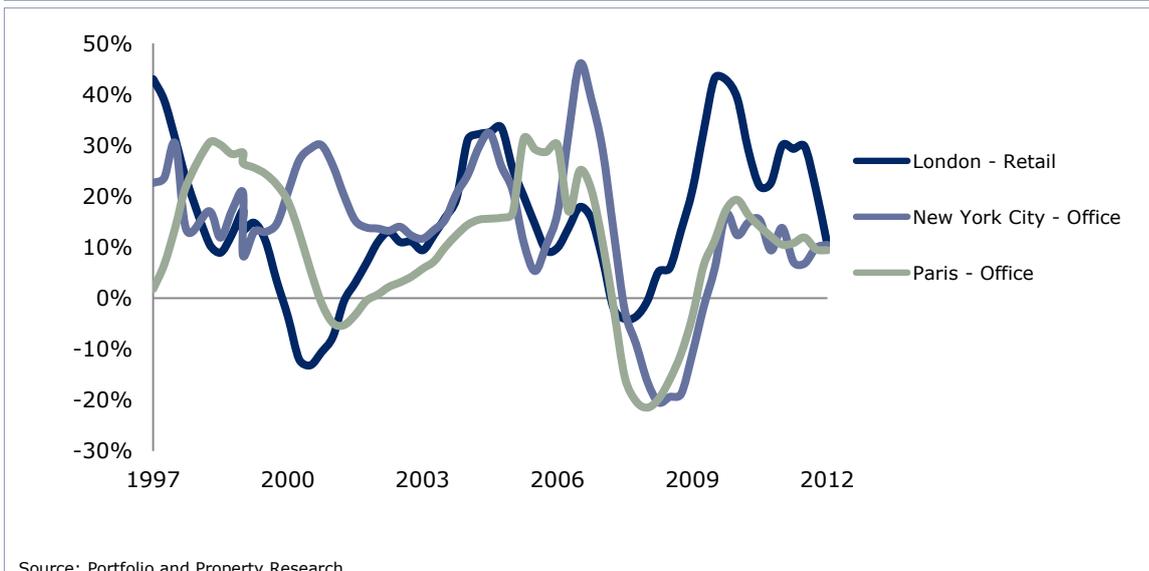
This often overlooked aspect of commercial real estate market composition can result in unintended concentration risk imbedded in real estate portfolios that mirror home markets. A portfolio bias to one's home market, that is assumed to be better "known," can thus result in significant overweights to property types that are most abundant, as well as an underweight to property types that may be less prevalent. Conversely, a real estate portfolio that mirrors the broader global opportunity set typically benefits from increased diversification and offers opportunities to invest in property types that may not exist in their respective home markets, or are dramatically underrepresented.

<sup>2</sup> Prudential Real Estate Investors. A Bird's Eye View of Global Real Estate Markets: 2012 Update, February 2012

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Unintended portfolio concentration as a result of regional biases can result in notable variations in performance. Given the lack of uniformity in real estate market composition (as shown in Exhibit 2), investors in different markets may see significant variance in sector exposure in their real estate portfolios, simply by way of stock and the opportunity set in their home market. In Exhibit 3, we evaluate the effect this has on the trailing 1-year real estate returns<sup>3</sup> based upon the dominant property type in three of the world's largest real estate metros, London, Paris and New York. As Exhibit 3 illustrates, over the most recent 3-year period, London's retail properties have significantly outperformed both the Paris and New York office dominant markets. Conversely, during the unwinding of the dot-com bubble, New York's office market continued to yield attractive returns as the markets of London and Paris saw declines. While Exhibit 3 does provide evidence that global real estate markets can move somewhat in tandem during certain economic cycles, it also illustrates that underweights or overweights to property types can cause decoupling in real estate returns.

**Exhibit 3: Trailing 1-year returns**



### MARKET CHANGE: PAST, PRESENT AND FUTURE

The institutional-grade global commercial real estate universe has changed dramatically from the real estate universe of ten years ago and is poised for even greater changes over the next ten and 20 years. In particular, real estate markets in the emerging economies will benefit from a "demographic dividend" as increased urbanization, population growth and a rising middle class workforce contribute to economic growth in developing countries.

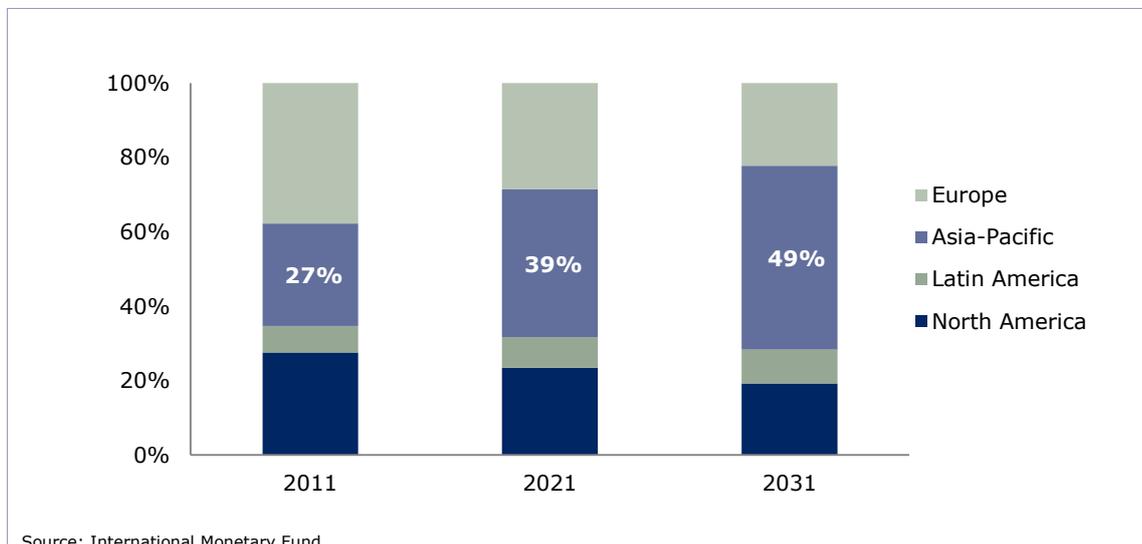
<sup>3</sup> Trailing 1-year returns are comprised of income and appreciation for underlying real estate properties

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In contrast, the mature markets of North America and Europe, which have historically offered the largest stock of commercial real estate and superior liquidity, will experience far slower economic development and potentially declining population growth. Nevertheless, these mature markets will potentially offer older real estate assets at discounted pricing with significant value-added repositioning and rebranding opportunities.

As illustrated in Exhibit 4, these regional trends will have significant impacts on the composition and investment opportunities in global real estate markets going forward.

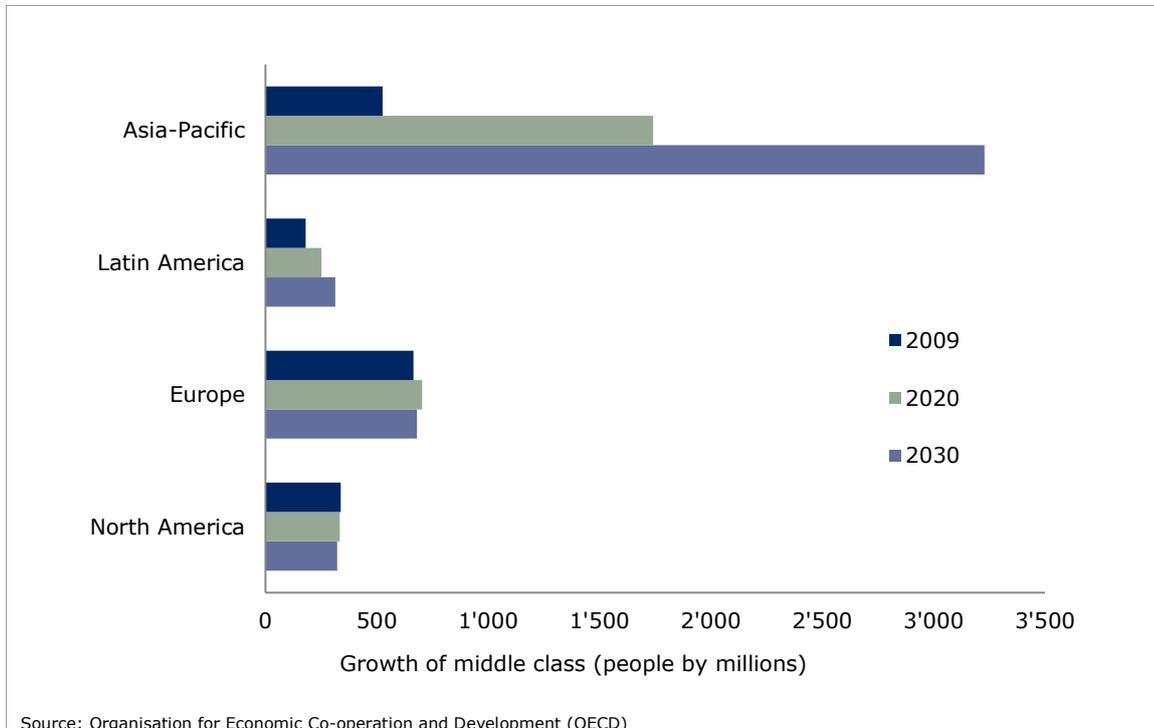
**Exhibit 4: Regional composition of global commercial real estate markets, 2011-2031**



The most notable shift in the global commercial real estate landscape will be the increased stock in the Asia-Pacific market which is anticipated to rise from 27% of the global universe in 2011 to nearly 50% of the market by 2031. Asia-Pacific's real estate market is projected to benefit from a number of growth drivers, including rising consumption, urbanization and improved GDP per capita. Additionally, a lack of class A commercial real estate stock in a number of major metros in emerging economies within Asia-Pacific will continue to drive development of office, hotel and apartment properties to support increases in consumer discretionary spending and GDP per capita. With nearly half of the population of the emerging economies in the Asia-Pacific region currently under the age of 40, the growth of the middle class is anticipated to far exceed developed markets (as illustrated in Exhibit 5) and will be a key driver in the further development of the commercial real estate market in this region going forward.

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**Exhibit 5: Growth of middle class by region**



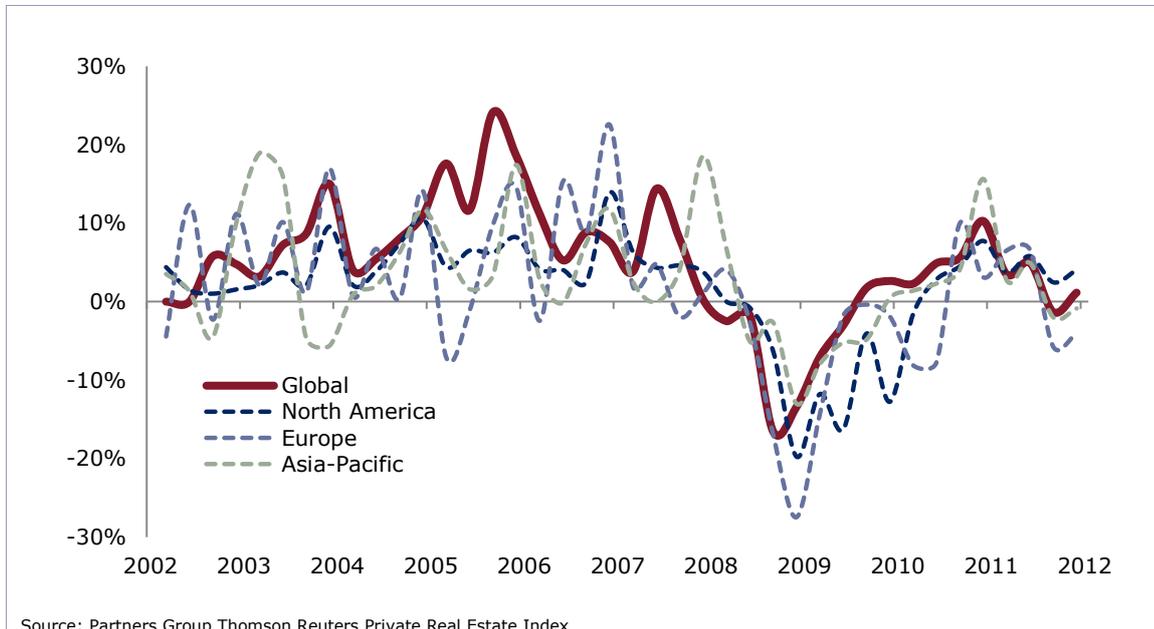
However, to attract international investors, these real estate markets will have to deliver returns that compensate for the additional risks and costs of implementing a global real estate portfolio. In the following section, we will evaluate these risks and the potential rewards that are being left on the table by many real estate investors.

## GLOBAL REAL ESTATE RETURNS AND VOLATILITY

Given the overwhelming lack of international exposure among real estate investors, it could be questioned whether international markets offered investors compelling enough returns to justify increased exposure? And what type of volatility have they experienced? How have these markets correlated with investors' domestic opportunity set?

To address these questions surrounding performance and volatility, analysis was done on the pooled quarterly return series of the Partners Group Thomson Reuters Private Real Estate Index, a performance database analyzing the cash flows and returns of private real estate partnerships globally. Private real estate investment programs were divided by geographic focus and the quarterly returns were reviewed over a 10-year period from 2001 to 2011. Exhibit 6 illustrates the rolling 1-year performance of managers that pursued a global focus versus those that were regionally focused.

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**Exhibit 6: Pooled average regional quarterly performance 2001-2011**


For the time period under review, the quarterly outperformance of global managers was notable. Globally-focused real estate programs were able to outperform their European-focused counterparts in 68% of the quarters by an average of 340 basis points. Similarly, globally-focused managers were able to outperform Asia-focused programs in 79% of quarters by an average of 190 basis points and outperform North America mandates in 84% of the quarters by an average of 329 basis points. The table below highlights both the frequency and amplitude by which global managers have been able to outperform over the period reviewed.

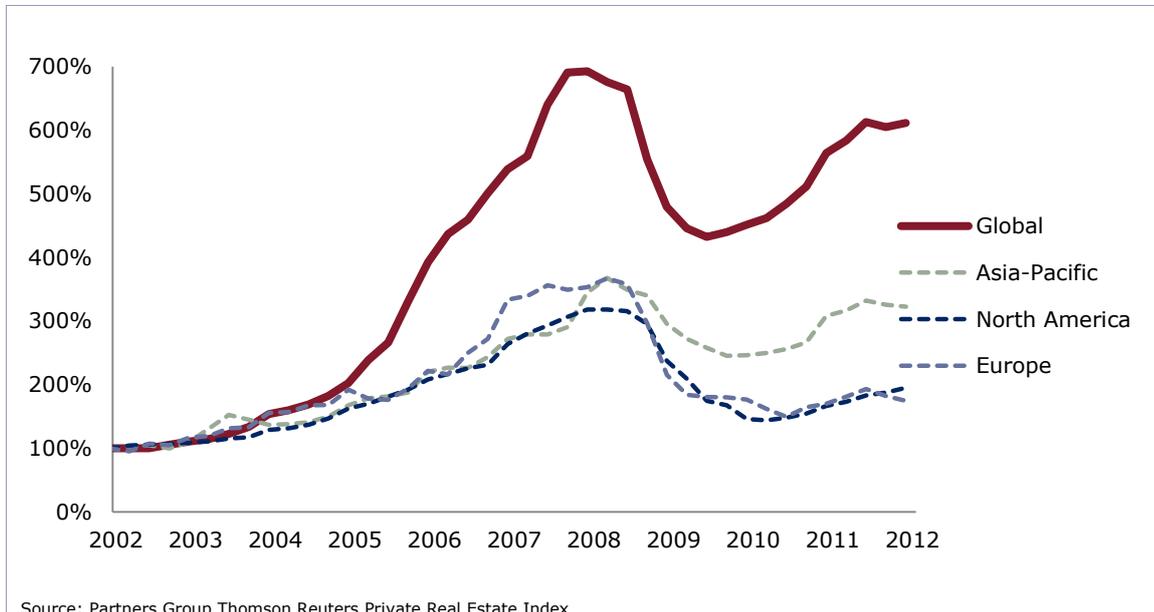
|                          | Global vs. North America | Global vs. Europe | Global vs. Asia-Pacific |
|--------------------------|--------------------------|-------------------|-------------------------|
| Quarterly outperformance | 84%                      | 68%               | 79%                     |
| Average outperformance   | 329 bps                  | 340 bps           | 190 bps                 |

Source: Partners Group Thomson Reuters Private Real Estate Index

Over the same time period, the cumulative performance for globally-focused managers far exceeded that of regionally-focused managers, as illustrated in Exhibit 7.

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**Exhibit 7: Pooled average regional cumulative growth, 2001-2011**



While globally-focused managers were able to outperform real estate programs with a regionally-targeted focus, these returns did tend to be achieved at slightly higher levels of volatility (as measured by annualized standard deviation). As shown in the table below, globally-focused strategies' pooled annualized standard deviation exceeded North America- or Asia-Pacific-focused strategies, but was lower overall relative to European-focused partnerships. While global strategies showed a slightly higher standard deviation, these programs also generated significantly higher returns per unit of risk.

|                          | Global | North America | Europe | Asia-Pacific |
|--------------------------|--------|---------------|--------|--------------|
| <b>Return (p.a.)</b>     | 20.4%  | 6.9%          | 5.7%   | 12.4%        |
| <b>Volatility (p.a.)</b> | 18.0%  | 14.6%         | 20.6%  | 16.6%        |

Source: Partners Group Thomson Reuters Private Real Estate Index

Given real estate's location-specific nature, these results may be somewhat counterintuitive or surprising to a number of investors. Yet, Partners Group's experience has been consistent with the results reviewed here and can be explained by the implementation of a systematic approach to assess the relative attractiveness of various private real estate markets through our relative value approach to investing.

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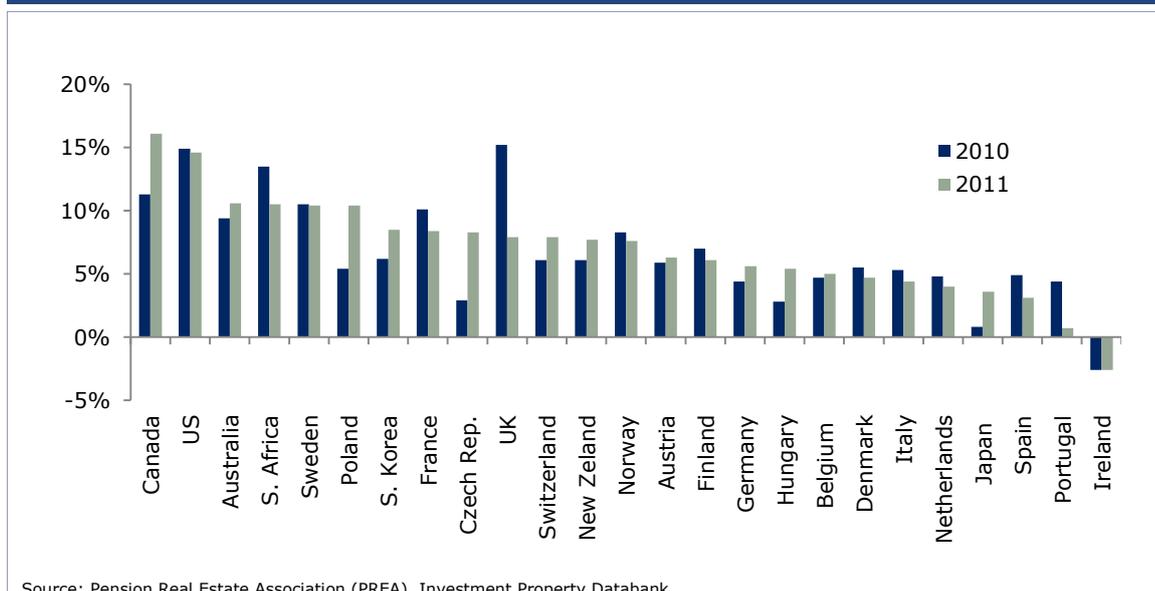
## HOW TO INVEST GLOBALLY

Success in global private real estate is only as strong as the strategy and efficiency with which one can capitalize on changing market conditions. The dynamics of global real estate markets influence the overall attractiveness of each market segment, region, country, city and property type. To compensate for the variability and speed with which markets move, each market must be regularly evaluated to determine attractiveness relative to a given opportunity set.

By way of example, at the core of Partners Group's investment philosophy is a "relative value" investment approach, which assesses the projected performance of an investment by taking into consideration the fundamental mid- to long-term real estate trends occurring in various market segments. These market segments are typically defined by type of investment, geographic region, value creation strategy and property type. Partners Group then strategically allocates capital to the segments of the private real estate market that the firm believes will offer the most attractive value "relative" to other segments at a given point in time, within strategic asset allocation ranges. This integrated, relative value approach provides the foundation for attractive long-term investment performance. This effort is strengthened through local networks, on the ground analysis supported by 15 office locations and a multicultural team comprised of over 50 nationalities.

To explore the relative value process in greater detail, Exhibit 8 shows aggregate country performance on a year-over-year basis. The Investment Property Databank Index series is an aggregate index of individual property returns worldwide. Performance trends for individual countries clearly illustrate the difficulty (and perhaps impossibility) in predicting top-performing countries on a short-term, annual basis.

**Exhibit 8: IPD country-by-country annualized 1-year returns**

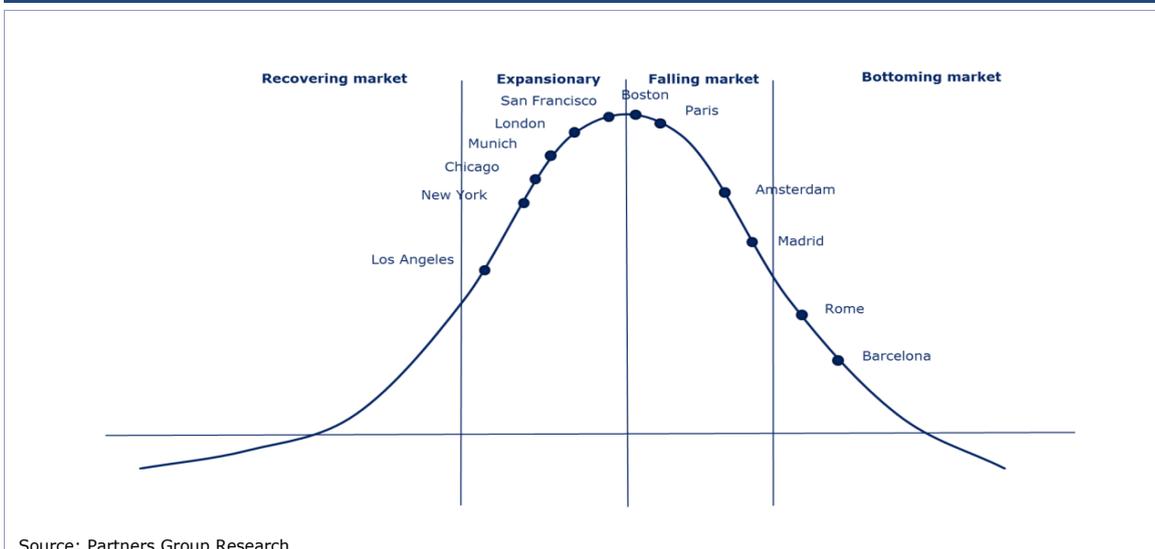


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While aggregate country outperformance may be difficult to predict on a year-over-year basis (illustrated in Exhibit 8), consistent long-term outperformance for globally focused programs is achievable. Rank orders of countries, regions and investment types may not always be exact, but major macroeconomic trends that evolve over a typical real estate cycle, such as deteriorating or improving market fundamentals or mega trends in emerging markets, are readily observable. A key to exploiting these trends and mitigating the year-over-year variations in returns is the ability to maintain a long-term approach. A five to ten year investment horizon allows sufficient time to let real estate cycles evolve and capitalize on tactical shifts in portfolio allocations.

Not unlike the volatility shown on a country-by-country basis, underlying metros and property sectors continuously cycle through different “phases” of recovery, expansion and contraction year-over-year. As an example, Exhibit 9 illustrates the phase of various office markets as of the end of 2012. Strategies that benefit from the ability to invest globally, across property types, leverage this sub-market and property type analysis to capitalize on upswings and avoid regional sub-markets in decline. Defining broad portfolio “bandwidths” that allow allocations to move in and out of attractive market segments with new investments but avoid concentration risk through real estate cycles, should have the greatest ability to exploit these market opportunities when they occur.

### Exhibit 9: Office property cycles

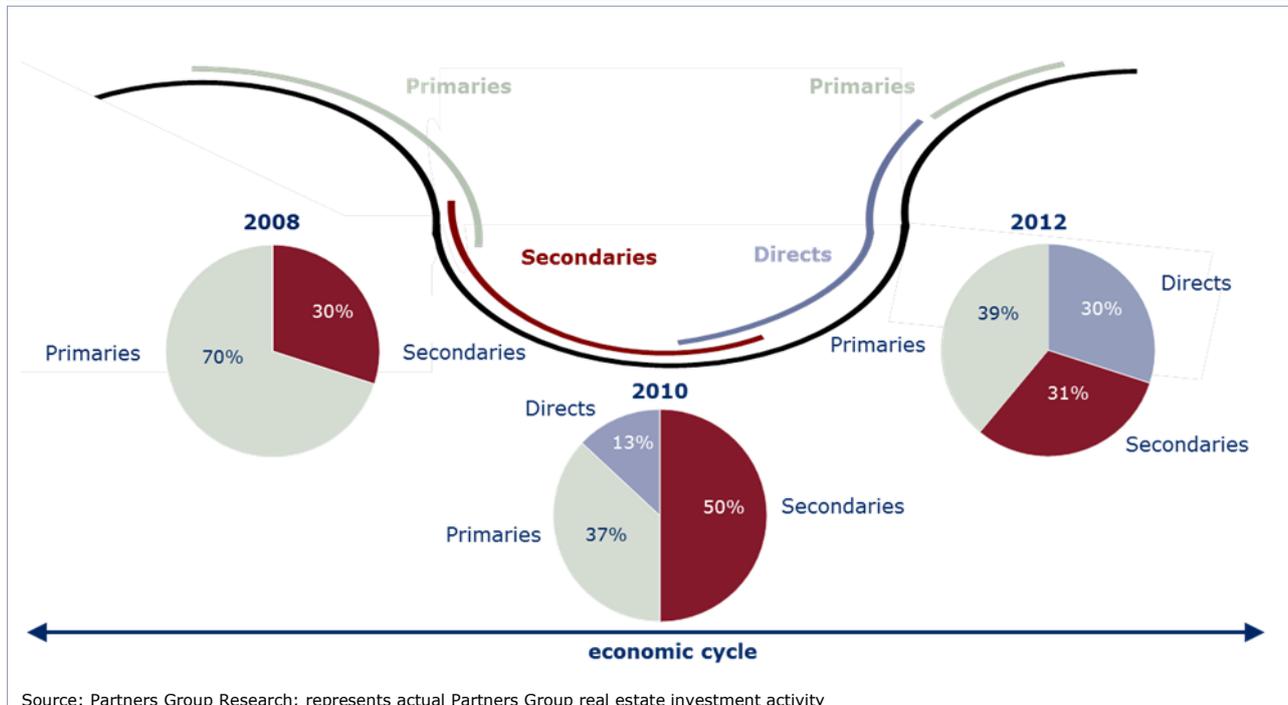


Finally, by leveraging an integrated approach (investing in direct, secondary and primary investment types), tactical shifts in portfolio allocations in accordance with the economic cycle can lead to attractive entry points into these respective investments during the correct economic phase. As shown in Exhibit 10, during market declines, liquidity constraints or portfolio management considerations can prompt existing owners of properties to seek exits on the secondary market at steep discounts to market value, which may offer attractive buying opportunities for liquid investors. Similarly, recovering markets can provide attractive buying

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opportunities for direct investments in order to immediately capture price uplifts and investments that offer greater opportunity to enhance value through active asset management.

**Exhibit 10: Investment allocations across cycles**

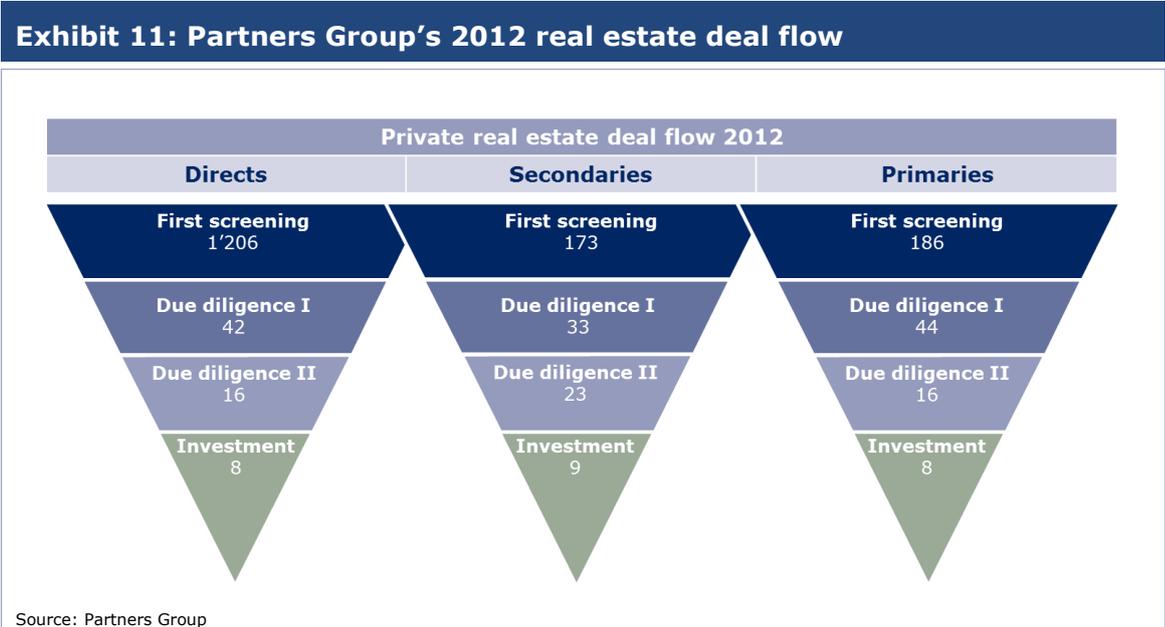


In practice, Partners Group's relative value analysis steers our global investment decisions. The analysis, comprised of regional, country and investment assessments, considers the economic cycle, the attractiveness of specific sub-markets, property sector performance and the desirability of different investment types to form the basis of our global investment strategy. Conducting analysis on investment instruments also allows us to capitalize on our integrated approach. A variation between direct, secondary and primary opportunities affords the flexibility to select between direct investments in specific target markets, secondary opportunities to acquire discounted positions in existing quality property portfolios and primary investments focusing on niche markets.

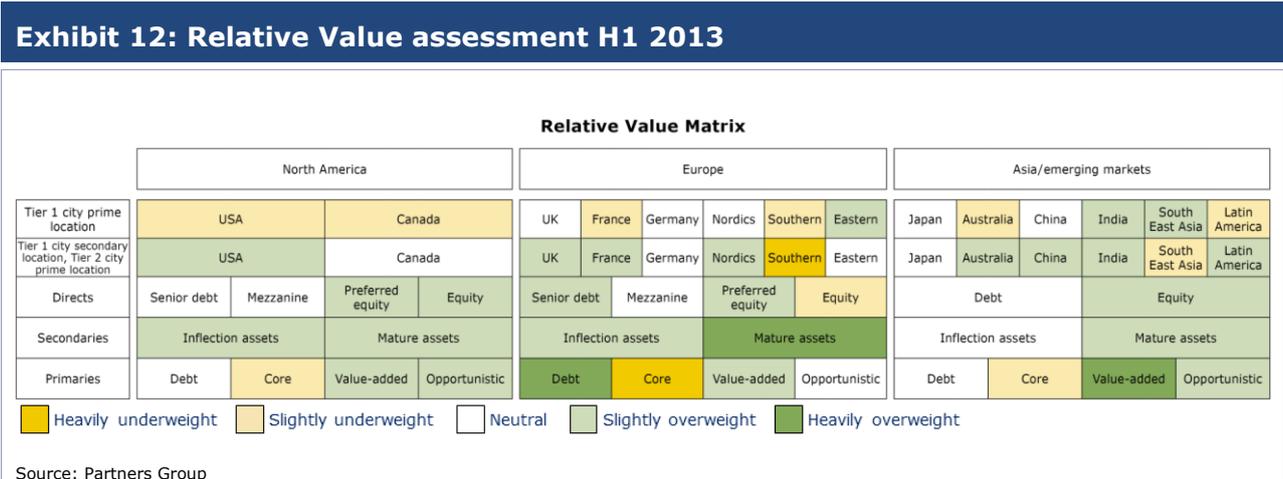
To ensure continued access to top investment opportunities, essential in the ability to implement a successful global strategy, a robust investment pipeline must be maintained. Proactive, bottom-up deal generation from a global set of sources provides a sufficient quantity of deal flow, which is a key prerequisite for applying a superior relative value strategy. Robust deal flow affords the ability to remain highly selective in the properties chosen for inclusion in the portfolio. Knowing the market, region or investment type you expect to allocate capital, as well as the anticipated risk/return profile of these investments, is a critical aspect to maintaining an adequately diversified and attractively positioned global portfolio. The chart

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below, Exhibit 11, provides insight into Partners Group’s deal flow for 2012. It illustrates the wealth of deal sourcing, coupled with highly discriminate investment selection.



Using different investment instruments (directs, secondaries and primaries) and over- and underweighting countries and regions across the economic cycle, we believe it is possible to enhance both portfolio level returns as well as a portfolio diversification characteristics. Exhibit 12 is an illustrative depiction of our relative value assessment for the first half of 2013.



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### **CONCLUSION: REALIZING THE BENEFITS OF GOING GLOBAL**

Based on the evidence reviewed in this research flash, adopting a global approach to real estate investing has proven its merit, generating returns over and above those of regionally constrained real estate portfolios. In addition, savvy real estate investors have become adept at exploiting this wider opportunity set, in order to gain favorable entrance and exit points into real estate cycles and property types that may differ from their home market. Consequently, investors that have adopted a global approach have benefited from the ability to tactically shift portfolio exposure along regional, country, city and property sector lifecycles according to the relative attractiveness of these investments at various phases of the economic cycle. Additionally, investors utilizing global platforms that benefit from large "on the ground" teams familiar with the nuances of local real estate markets and local networks are likely to experience robust deal flow. This deal flow affords the opportunity to be highly selective among the investments considered for inclusion in their real estate portfolios. Ultimately, the implementation of a systematic approach which weighs the relative attractiveness of real estate market segments across the globe and capitalizes on access to these investments through direct, secondary and primary investments will be able to generate the most compelling returns and benefit most from going global.

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