Dispensing with tradition

Full pricing in the 'traditional' secondaries market is leading global investment manager Partners Group to take on more 'non-traditional' secondaries to find compelling returns for its investors. By Thomas Duffell

Zug, Switzerland: home to Partners Group

Real estate markets in many parts of the world can be considered to be nearing cyclical zeniths. As such, many buyers within the real estate secondaries space – which traditionally involves the acquisition of LP stakes in property funds – are cautious.

"You really have to question in this point in the cycle, does it make sense to pay close to par for funds that are close to winding down?" says Marc Weiss, partner and head of the private real estate secondaries and primaries business unit at Partners Group.

The Zug, Switzerland-headquartered investment firm amassed the largest pool of dedicated capital for real estate secondaries when it closed on $1.95 billion for its Partners Group Real Estate Secondary 2013 fund, almost double the original $1 billion target, according to *PERE* data.

"There is plenty of opportunity in the market for experienced secondaries investors, but you need to go off the beaten track to find it. I think if you look at what is being offered up by sellers in the 'traditional' secondaries market, probably with the exception of the portfolios of CalPERS and a handful of other similar sized investors, the overall pool of what could be sold is getting smaller," Weiss continues.

He adds that this is why there are not many new entrants to the market on the one hand, and why the few new players there are find it challenging to get access to investment opportunities and deploy capital on the other hand.

"If you look at the traditional space you are going to find opportunities mostly from public pension plans and probably some endowments and foundations that are trying to wean themselves off their pre-GFC funds – although they tend to be acutely price sensitive. You have to think back to motivation: if the seller is not very motivated to sell, what is the point of them accepting anything that is not close to par?" says Weiss.

The opportunities of the past, such as banks and insurance companies selling down their fund exposure due to regulatory constraints, are not as readily available today: "There is still a bit they have to part with on the private equity side, but when it comes to real estate, a lot have already cleansed what they wanted to sell. I think there will be far fewer opportunities there than anywhere else."

The story in the US and Europe is similar and the types of secondaries sellers do not vary significantly in that they are typically financial institutions, pension funds, and endowments and foundations.

Weiss: going off the beaten track for opportunities

Neuenschwander: concept becoming more recognised

Lempen: no easy secondaries transactions anymore

Yet, the challenging macroeconomic and geopolitical situation in Europe is creating greater opportunities, says Stefan Lempen, senior vice-president, co-head private real estate secondaries at Partners Group. “What is helping us is the political uncertainty in the UK surrounding Brexit. It generally plays in our favor when there is a level of uncertainty of money moving into or out of a market.”

Still, an increasing part of the seller universe is being made up of property funds or funds of funds looking to lock in an IRR, Lempen adds.

Breaking with tradition

The challenge global secondaries specialists now face is whether they can shift the focus from traditional secondaries to ‘non-traditional’ secondaries. One type of non-traditional transaction is a GP-led restructuring, with much of the current market opportunity focused around more mature vehicles approaching the end of their fund life.

With GP-led transactions, the goal is not only to acquire a fund stake and become a new LP. It is also about being a long-term partner to the GP. These transactions are more complex because they involve several parties: all the LPs, the GP and at least one secondaries buyer. Historically, they were associated with GPs unable to raise money in the primary market and had a certain stigma attached to them, but not anymore.

A lot of the deaflow on the non-traditional side comes straight from the GPs, says Weiss. “They are the ones in the situations where they need to wind down these pre-crisis funds and still have a lot of assets where there remains the potential to create value with some combination of more time and/or more capital, or the opportunities come from operating partners who are under pressure to sell assets in JVs because the fund managers with whom they are partnered with want to liquidate, but the operating partners have an infinite time horizon.”

$985m

Value Partners Group invested in real estate secondaries in 2016…

79%

…volume of which was in non-traditional investments

Source: *Partners Group*

“An increasing amount of transactions in Europe consist of a counterparty that is not the investor, but the manager of the property fund trying to achieve full liquidation of the fund,” adds Lempen.

That is not to say Partners is moving completely away from the traditional space. Rather, Weiss says, the firm is just putting more emphasis on non-traditional opportunities given where the real estate markets are currently, but will keep doing traditional deals on behalf of its clients when prices are right.

“Our view is that traditional secondaries, regardless of who they are coming from and how big they are, are beta trades. You buy an LP interest in a fund and you have access to whatever information is available to you, and I would argue that our business has better access than most in the industry, but just the same it is a beta trade. You have all the same rights, but also limitations, as a limited partner and therefore if you can’t make the money on the buy-side, you’ll never be successful. For beta trades, you have to price it right – if you can’t price it right in that market environment you shouldn’t buy it,” says Weiss.

He adds that high internal rate of returns can still be made on traditional secondaries as the more mature funds in market are generating a lot of cashflow. But, he says to make good multiples that capital needs to be recycled to another mature portfolio. “Those focusing on traditional deals really have to bet on recycling capital or using quite a bit of leverage – and both of these strategies generate another layer of risk to the investor.”

Not that the move towards non-traditionals for Partners Group occurred overnight. Weiss says that since 2013, non-traditionals have become an increasing part of what Partners Group does, last year representing around 75 percent of its overall transaction volume, and he expects it to be the same this year too.

“More recently, we have seen an increase in dealflow for non-traditional secondary transactions in the US and we expect to do more on that front going forward. GPs and LPs are familiarizing themselves with this concept – it is still new for many, but they see the benefit for everybody involved,” says Fabian Neuenschwander, senior vice-president, co-head private real estate secondaries at Partners Group.

For instance, back in July, *PERE* reported that Partners Group invested $265 million on behalf of its clients in a portfolio of seven retail, mixed-use and development property

Trophy room: Partners Group's marquee secondaries deal in Asia saw it buy assets in Shanghai from investors exiting Trophy Property Development

assets in the US. The investment involved the restructuring of an existing mature fund. The portfolio was part of a 2006-vintage program managed by Madison Marquette and includes retail centers in California and North Carolina totaling around one million square feet of lettable area, and large-scale mixed-use waterfront development projects in Washington DC and Asbury Park, New Jersey. Partners Group will work with Madison Marquette to operate the assets and complete renovation and development plans.

"Giving an LP liquidity at a late point in the fund life or inviting them to participate in the potential upside from a restructuring, as well as giving a GP the chance to create further value, is also a much more interesting play for us," says Neuenschwander.

Nascent Asia

The rise of non-traditional secondaries is not restricted to the more mature and liquid real estate markets, the US and Europe.

"We see non-traditional secondary opportunities in Asia becoming increasingly more interesting as more sellers emerge and begin to consider potential sales. The uncertainty created by both macroeconomic and market events in the region have been an impetus for this activity. We have investors that naturally want less exposure to Asia, causing them to reassess their portfolio allocations to the region," says Wataru Miura, vice-president, private real estate Asia at Partners Group.

Partners Group's marquee real estate secondaries deal in Asia, as reported by *PERE*, was in 2014 when it purchased the stakes of 31 exiting investors in Trophy Property Development. Trophy was a $1 billion China-focused property development program operated by Venator Real Estate Capital Partners and the minority owner of five development projects in China through a partnership with Shui On Land, a Hong Kong Stock Exchange-listed real estate developer.

Trophy was formed as a seven-year program by Winnington Capital in 2007. But after a restructuring in September 2013, Venator replaced Winnington as investment advisor to Trophy's general partner and initiated an asset swap with Shui On Land. They exchanged Trophy's minority stakes in the five original projects for a majority stake in Taipingqiao 116, a 968,000-square-foot residential development located in central Shanghai.

Over the course of the restructuring, the program's advisory board approved a two-year extension to the life of the program to April 2017. To secure a short-term liquidity window, a tender offer process was subsequently launched to find a solution for investors seeking an exit from the restructured program. Miura says: "Just given the fact that we are seeing quite a few real estate funds coming to the end of their fund terms, if these funds have assets that need a bit more work or time, there is a natural propensity for GPs to consider a discussion with us about a liquidity solution."

Yet, despite there being some big opportunities, the challenge in Asia is that real estate secondaries is still a nascent strategy. The primary fund universe is relatively small compared with other parts of the world, and a large proportion of real estate is tied up in non-traditional fund or open-ended structures catering to core investors.

Miura says: "Property in Asia is still predominantly viewed as a store of wealth, so the market of sellers becomes even smaller when you take that into consideration. And even for the global players, the allocations to Asia are smaller and so wholesale decisions get less attention."

The same reasons that cause potential sellers to weigh up whether to reduce their Asia positions are a potential cause for concern for a secondaries buyer.

"If you look at some of the emerging markets where you have a lot of currency risk, and you may not be able to hedge or it is expensive to hedge, then you factor that into cashflows and depreciation assumptions which naturally impact the potential return premium for those assets," says Miura.

New horizons: real estate secondaries is still a nascent strategy in Asia

Deal difficulty

These complex non-traditional deals are also still challenging to explain even as the real estate world begins to get educated on this opaque area of the marketplace.

"GPs are a little bit reluctant, but the concept is more and more out there and it is becoming more accepted by both the GP and LP community in the US. There are still a few that are a little hesitant, but we have come a long way," says Neuenschwander.

Miura agrees and says there is still time that needs to be spent talking to GPs and investors about the types of secondary transaction that can be structured and for which different reasons.

"There is no easy transaction anymore," agrees Lempen, who adds that one of the most difficult aspects of the non-traditional secondaries market is convincing the seller. "Sellers have more options these days so don't always need the secondaries market. Sometimes they don't want to sell because they simply don't know what to do with the money next. That's a state of the market that has not been apparent before. Sellers are wary about making a decision one way or another."

Non-traditional deals are also complex, as the transfer of property ownership as a result of a non-traditional secondary usually triggers a refinancing of the existing debt arrangements. It might also involve a consolidation of the existing ownership or capital structure through the buyout of minority shareholders or repayment of expensive junior debt. For example, when Partners Group purchased a real estate portfolio of retail and office properties in Finland and Sweden from Nordic property investment manager Niam on behalf of its clients, *PERE* reported that Partners also negotiated the refinancing of all existing debt facilities, as well as the buyout of minority shareholders and joint venture partners and the prepayment of a mezzanine facility incumbent in the capital structure.

As such, there is a certain premium attached to these deals, although it is not considerable, says Lempen. "I would say a non-traditional secondary probably attracts an additional multiple premium versus a traditional transaction, but that is mainly due to the additional time and resources you have to put into these transactions. I would say the average time it takes to close a non-traditional deal is between three and six months, while a traditional portfolio transaction could take as little as three months."

But, with many real estate markets reaching, or even surpassing, peak pricing and a dearth of motivated 'traditional' LP sellers, the extra time it takes to secure a non-traditional secondaries deal is well worth the wait, agrees the Partners Group team. □