

Seize the opportunity

US investors have increased their sophistication in real estate investing – more private real estate, a greater risk appetite and use of synthetic investment tools. **Rob Kochis** and **Christopher Lennon** report

Although the unravelling of the credit markets is having a significant impact on the day-to-day activities of many investment managers of private equity real estate vehicles, it is too early to tell if it will have a corresponding effect on the investors in these vehicles. For institutional investors such as pension funds, the most evident effect might be the so-called denominator effect: declines in public market investments cause the total plan assets to decrease in value faster than the real estate holdings, resulting in the plan being over-allocated to real estate. Asset owners faced with this situation are often forced to sit on the investment sidelines until the allocation comes back in line with the strategic objective.

Although many institutional investors are gearing up to revisit strategic decisions such as real estate allocations as they enter the traditional Fall planning season, anecdotal evidence suggests they are not shying away from real estate. Many appear to view the current environment as providing a tactical opportunity. In this article, we look at the immediate impacts of the credit crisis on real estate investors, who often use debt to leverage real estate investments and returns. These observations are put into the broader context of the role that private real estate typically plays in an institutional investment portfolio. We also review the evolving use of leverage in commingled investment funds that often make up a typical institutional real estate programme. Finally, we look at how the current environment has spawned new opportunities for investors to achieve their investment targets – including a surge in debt-related funds, and a budding market for synthetic alternatives.

The most obvious impact of the credit crisis has been a sharp and immediate drop in the number of property transactions. As Figure X shows, one of the best measures of property sales by institutional investors has declined to levels not seen since the early 1990s. The percentage of properties bought or sold within the NCREIF Property Index (an index comprised of some 6,000 properties with a combined value of more than \$300bn (€204bn) in 2008 is under 5%. It is impossible to determine how much of the decline is caused by credit market conditions, softening fundamentals, or increased uncertainty about the future of the market. All have played a role. Many potential sellers have been taking properties off the market given the current wide disparity between what the market is willing to pay and what they believe the properties are worth.

Despite the slowdown in the economy and real estate transaction volume, the performance of private real estate markets (as measured by the NCREIF ODCE index) has yet to turn negative. As Figure Y shows, the past five years of very strong performance has slowed considerably in the past few quarters, and the return is effectively zero for the second quarter of 2008. If the trend continues, this return will likely be negative for the first time in the third quarter. Indeed, the derivatives market is anticipating negative returns in the NCREIF Property Index for approximately the next two years. For the time being, however, investors continue to see positive returns – 7% total return for the 12 months ending 30 June 2008.

Real estate programmes have grown substantially in both size and complexity over the past decade. In the mid-1990s, it was common for a large public pension fund in the US to have minimal (under 4%) real estate

exposure. Such institutional investors were generally risk averse. Most of their holdings were in high-quality stabilised (usually substantially leased) properties. The ownership structure was direct ownership, and the investment was expected to return 'somewhere between stocks and bonds'.

In time, asset owners became more sophisticated in their approach to asset allocation and portfolio construction. Plan sponsors focused on real estate's low correlation with the traditional asset classes, as well as its potential to match liabilities better than fixed income by adjusting with inflation. Real estate became more accepted as an asset class. Allocations to real estate increased. Figure 1 shows the allocation to real estate arranged by plan size for approximately 60 public plans today. It shows allocations are reasonably insensitive to plan size and range from 5% to 10% of the total assets – with a few plans making even larger allocations.

In addition to increases in the overall allocation, the product mix available to real estate investors has also changed over time. This has been led largely by the demand from asset owners for outperformance in each asset class in which they invest. As plan sponsors push to extract alpha from every portion of their portfolios, real estate benchmarks have evolved past that of simple unlevered property returns reflected in the NCREIF Property Index (NPI). Investors often established mandates to outperform the NPI by 2-3% or more. However, a very narrow dispersion of returns for core managers forced pension funds to identify other ways in which to achieve their target returns. The strategy often became a core-satellite approach, similar to a typical equity programme. The core real estate programmes become the mechanism to acquire beta-like exposure to real estate markets, while higher-risk tactical investments offered an avenue to achieve excess returns above the core market.

The trend toward more tactical 'value added' or 'opportunistic' investing is clear. Figure 2 shows the average allocations to investment styles among the real estate programmes of 35 large public plans. The allocation to core funds has become less than half of the

FIGURE X: TRANSACTIONS PER YEAR OF THE NPI INDEX AS A PERCENTAGE OF TOTAL PROPERTIES

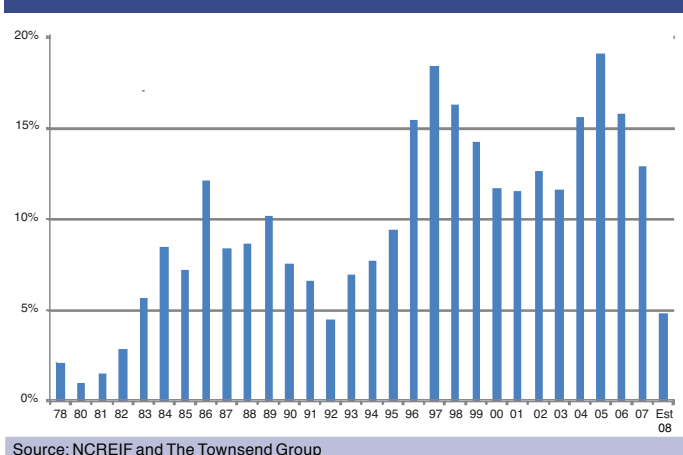


FIGURE Y: FIVE YEARS OF NET RETURNS FOR THE ODCE INDEX BY QUARTER

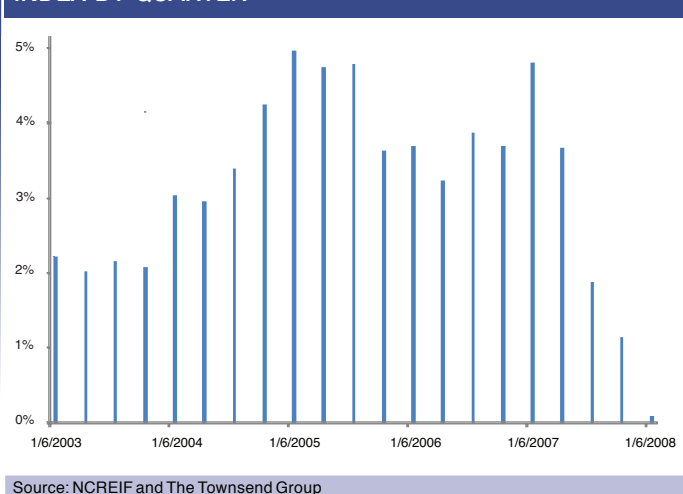


FIGURE 1: ALLOCATION TO REAL ESTATE BY US PENSION PLANS AND ENDOWMENTS SIZE BY PLAN

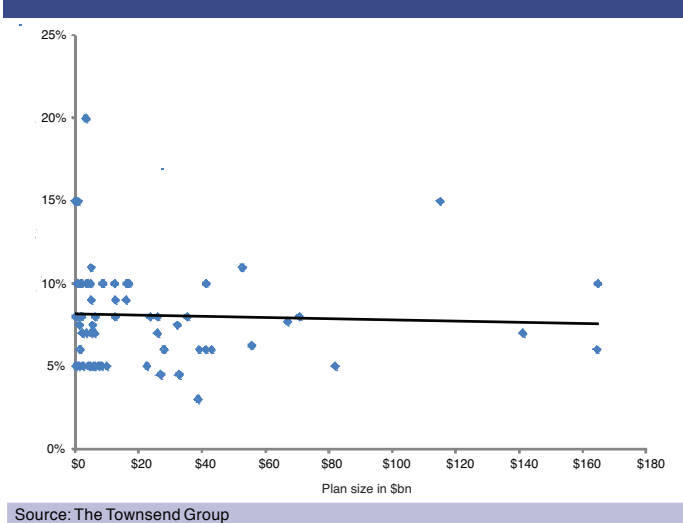
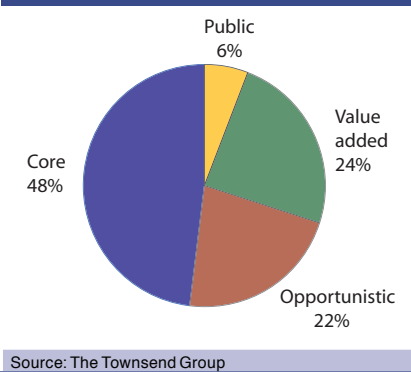
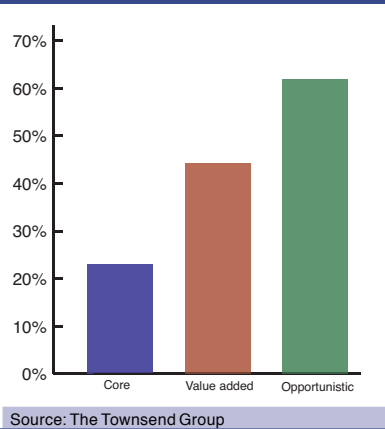


FIGURE 2: ALLOCATION BY INVESTMENT STYLE FOR REAL ESTATE PROGRAMMES OF LARGE PUBLIC PLANS



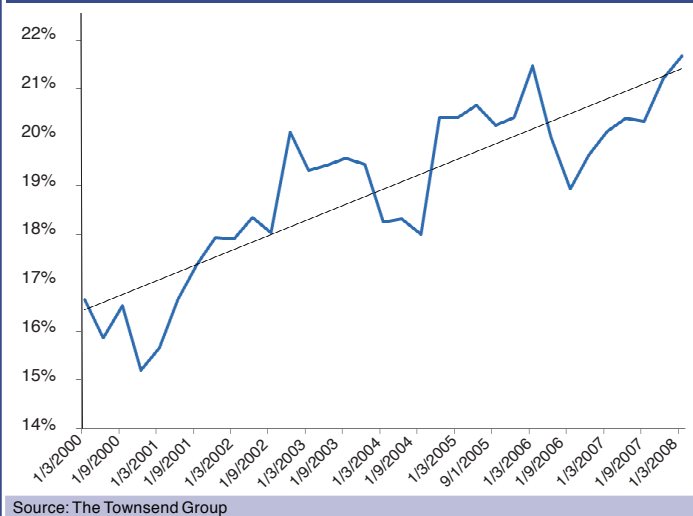
Source: The Townsend Group

FIGURE 3: LOAN TO VALUE RATIOS BY INVESTMENT STYLE



Source: The Townsend Group

FIGURE 4: LOAN TO VALUE RATIO FOR THE US CORE REAL ESTATE FUNDS OVER TIME



Source: The Townsend Group

total on an invested capital basis. When the impact of leverage is considered, the proportion falls even further. Opportunistic funds, of which there were few 15 years ago, have grown to about a quarter of the total portfolio based on invested assets. Real estate programmes became far more sophisticated as real estate became more accepted as a traditional institutional asset class.

The use of leverage varies significantly across investment styles. Figure 3 shows the average loan-to-value ratio for funds categorised by the typical investment styles (core, value added and opportunistic). It shows a steady increase among the investment styles, starting from just over 20% for core funds and exceeding 60% for the opportunistic funds. These figures are derived from information included in a quarterly publication jointly released by NCREIF and The Townsend Group.

Although figure 3 shows the much larger role that leverage plays in opportunistic funds in general, the averages often hide the fact that some funds engage in much higher amounts of leverage (some as high as 80% or 90% loan-to-value). Also, in some cases, fund managers under-report their leverage. For example, they fail to include off-balance-sheet debt from joint ventures and other non-consolidated investments. This means that the figures probably understate the amount of leverage employed – in particular for opportunistic funds. This type of fund is more likely to encounter difficulty replicating its strategy under today's market conditions. Opportunistic funds, in particular, run the risk of being over-extended if a refinancing becomes necessary.

The amount of leverage has been rising across funds in all the investment styles over the past 10 years. As low interest rate debt became widely available, and real estate values steadily increased, the decision to make more use of leverage seemed easy. While the most pronounced increase is believed to have occurred within the universe of opportunistic funds, reliable historical data is not available. Figure 4 shows the increase over time for core funds over the last 10 years. Although the absolute increase is less than 5% on a loan to value ratio, it does represent an almost 30% rise in relative terms.

The secular shift into real estate, together with strong underlying fundamentals, has led to a period of sustained real estate price rises and record low cap rates for US properties. The combination of rich pricing and softening fundamentals has led to a period of market uncertainty. Transaction volume has declined substantially from the peak as the bid-ask spread on properties has widened considerably from levels in the run-up in the market. For sellers, it seems, the first law of cartoon physics has taken hold: anybody suspended in space will remain in space until it is made aware of its situation. So, unless compelled to do so, sellers are unwilling to sell at the lower prices buyers are demanding.

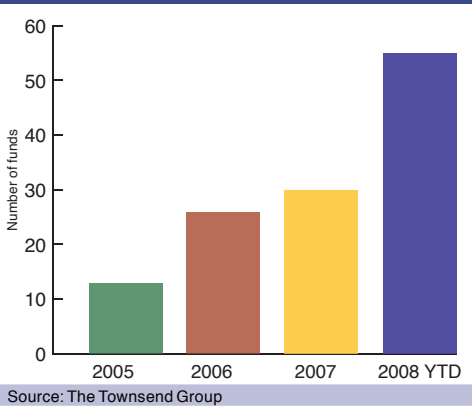
Indications are that capitalisation rates have begun to crawl back up for most property types and across most geographies. This should unlock current frozen market conditions. For investment funds currently raising capital, the expectation is that managers should be able to find investing opportunities as the

market softens. But there are a host of other market participants that are hoping to take advantage of the state of disequilibrium in the credit markets.

As large banks have cut back on credit extended to the highly levered opportunist funds, a market void is expected to open up when any refinancing comes due. A flood of 'debt' funds have marketed themselves to investors as being able to fill that void, by lending to the over-extended opportunist fund managers who need to roll debt acquired during the peak of the debt cycle. The hope of the debt funds is that they will be able to price this debt at far more aggressive terms to provide equity type returns for investors with debt-type risk.

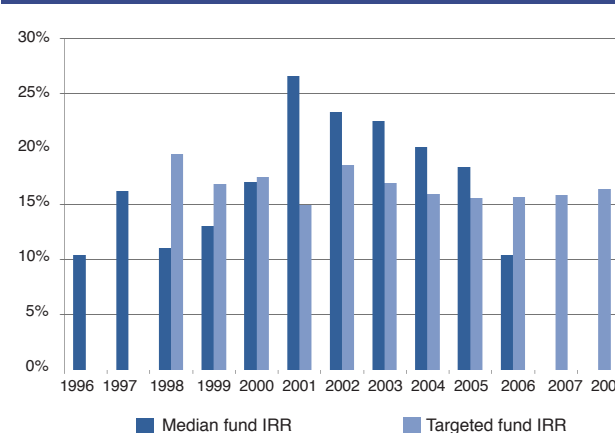
Figure 5 shows the number of private equity debt funds marketed to institutional investors. This strategy has grown substantially in size as the credit cycle has

FIGURE 5: DEBT FUNDS MARKETING TO US INSTITUTIONAL INVESTORS



Source: The Townsend Group

FIGURE 6: REALISATION VS EXPECTATION OF FUND RETURNS BY VINTAGE YEAR



Source: NCREIF and The Townsend Group

wound down. These figures do not include many similar strategies offered by hedge fund or fixed income managers. Because private equity debt funds were designed to exploit a market inefficiency with an uncertain duration, many were raised very quickly.

Another market opportunity that might benefit from the current environment is the synthetic market. While the property derivatives market has been gaining traction in the UK, it has been slow to catch on in the US. The current expectations for negative returns from the NPI, however, seem to provide an opportunity for plans that wish to put new money to work, and secure a spread above the widely used index.

An investor looking to enter into a total return swap to receive the NPI returns for the two years ending in 2009 will, instead of paying, actually receive 2% for accepting the index returns. Although usually a thinly traded market in the US, the opportunity to use derivatives to lock in a premium above the NPI index has drawn interest from market participants. Several large trades have begun to take place at these levels.

Finally, as the market cools, measuring and understanding performance will grow in importance. The Townsend Group/NCREIF Fund Indices, released for the first time earlier this year, are designed to help investors interpret the performance of funds in the various non-core investment styles. Figure 6 shows internal rates of returns for opportunistic funds that contribute return information by vintage period. Because the closed-end funds in this universe have an average term of about seven years, and the active market tended to speed up the investment cycle, funds in the 2001 and 2002 vintage periods were able to post very strong performance. It is too early to tell how the later vintages will perform, but few expect the blockbuster returns of the peak vintage periods.

Most would agree that real estate has secured its position as a traditional asset class for US institutional investors. Difficulties in credit markets might challenge investment real estate managers but they are likely to do little to alter the strategic decisions of plan sponsors to allocate investment capital to real estate.

What appears clear from the plan sponsor community is that the time of easy returns is drawing to a close. We are entering a period where investors will have to be more selective in identifying opportunities. Growth in the volume and complexity of investment offerings will make the time invested in investment due diligence more important than ever.

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