GLOBAL REAL ESTATE MARKET NEWSLETTER

MARCH 2016

GLOBAL REAL ESTATE MARKET OVERVIEW

While many of the same cautious themes persist from the prior issue, we are now approaching investment opportunities with increased skepticism as we are six months further into the cycle. As shown below in **Figure 1**, private core U.S. real estate continues to outperform other asset classes. We may sound like a broken record, but this performance coupled with a dearth of yield-generating opportunities elsewhere continues to drive record capital inflows into the asset class. Looming questions remain regarding the impact of low oil prices on allocations from commodity-rich sovereign funds, but we do not foresee any meaningful pullback in capital in the near-term as REIT and FIRPTA reforms should only increase foreign demand for U.S. real estate. As we expected, the commercial real estate world seems to be taking the Fed's first rate hike since 2006 in stride. Stimulus measures continue in much of the developed world despite policy shifts in the U.S., promoting greater fundraising levels in Europe with each passing quarter. Absorption continues to outpace supply in most sectors, but we are watching carefully for signs that valuations extend beyond those suggested by underlying fundamentals. **Figure 2** represents the impact of the aforementioned effects on U.S. property prices with values now approximately 23% above prior cycle peak levels. We believe real estate will remain attractive vis-à-vis other asset classes as long as global rates remain low, but finding value today is as difficult as ever.

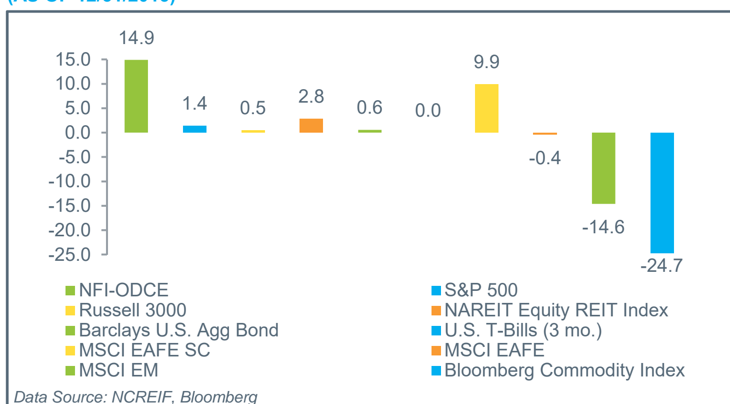
Contact Us:

RealEstate@rvkinc.com
Phone: +1 312.445.3100

About RVK Real Estate

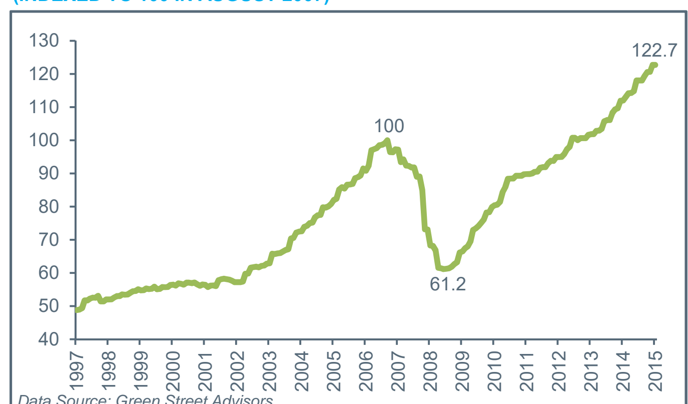
The first issue of the RVK Global Real Estate Market Newsletter delved into portfolio aggregation opportunities in senior housing, "bricks and sticks" retail in the internet era, and our differentiated (and cautious) outlook on the apartment sector. Now we turn our attention to South America, and specifically Brazil. While investing in an uncertain political climate is not for the faint of heart, we believe Brazil is one of the few markets on the planet that still offers the potential to acquire assets at distressed pricing levels. For investors that can isolate the real estate opportunity and accept currency risk, this is one "out of favor" country that warrants further consideration. Co-investments are another hot topic today, but our view is that they serve more purpose as a portfolio construction tool rather than an alpha generator, and concentration risk should be avoided at this point in the cycle. We should emphasize again that our views are NOT blanket recommendations. We firmly understand that circumstances differ for each portfolio, which is what makes customized client solutions the true hallmark of RVK's real estate consulting philosophy.

Figure 1: TRAILING 1YR MARKET PERFORMANCE (%)
(AS OF 12/31/2015)



Data Source: NCREIF, Bloomberg

Figure 2: COMMERCIAL PROPERTY PRICE INDEX
(INDEXED TO 100 IN AUGUST 2007)



Data Source: Green Street Advisors

About RVK – *RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm derives 100% of its revenue from investment consulting services and is headquartered in Portland, Oregon, with regional offices in Chicago and New York City. Based in Chicago, the RVK Real Estate Consulting Group advises a wide array of governmental, corporate, endowment, and foundation clients on both a retainer and project basis. Services include real estate policy development, strategic planning, portfolio construction and risk mitigation, real estate manager sourcing and due diligence, portfolio monitoring, performance reporting, secondary sales advisory, and co-investment and direct asset reviews, among others.*

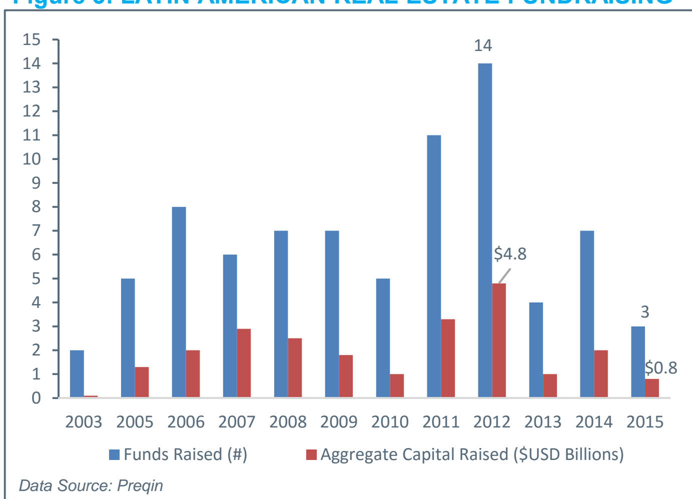
CURRENT REAL ESTATE INSIGHTS AND OPPORTUNITIES

The Emerging Case for Brazilian Real Estate

Latin America continues to be underrepresented relative to other global markets in most real estate portfolios. We have been underwriting the region for several years but did not believe the opportunity was ripe enough to dig deeper until recently. So why now? The short answer is that most investors seem to be running for the exits, which in our experience may signify a potentially attractive entry point for long-term investors. Members of our team spent time in South America in 2015 and our attention quickly turned to the Brazilian market. Brazil is huge – with a population over 205 million, it represents over 1/3 of the total population in Latin America and nearly 40% of total GDP, and is nearly twice the size of Mexico, the next largest contributor. With a collection of smaller economies, complicated political systems, and other idiosyncratic country risks, we believe a pan-regional strategy would be necessary to achieve scale outside of Brazil.

It's no secret that Brazil's economy is mired in some very deep problems. GDP shrank nearly 4% in 2015 and is expected to remain substantially negative through 2016, while the economy was basically flat between 2011 and 2015. Oil and commodity prices have deteriorated along with the currency (more on this later) and corruption scandals are permeating from the private sector into the upper echelons of the current administration. Unpopular but necessary reforms are receiving so much public pushback that the recently appointed finance minister has resigned, and impeachment discussions have commenced against President Rousseff. So why consider this at all if the macro outlook is so bleak? Our view is that this pain may be driving opportunity.

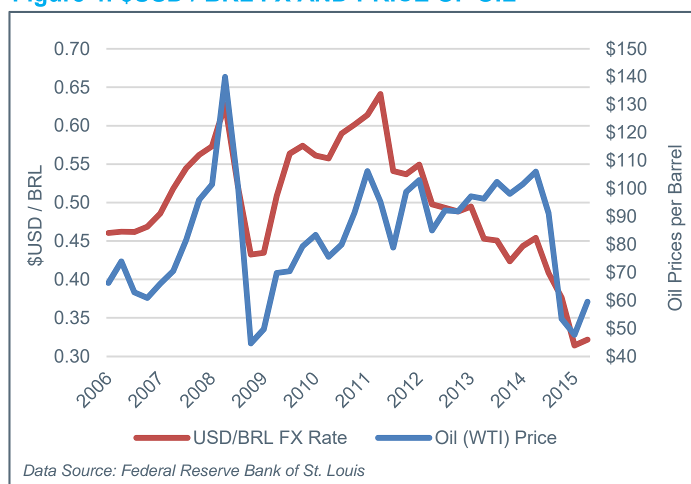
Figure 3: LATIN AMERICAN REAL ESTATE FUNDRAISING



Data Source: Preqin

As shown in **Figure 3**, fundraising for private real estate in Latin America is near an all-time low, well off the robust volumes from only a few years ago. This dearth of capital could provide opportunity for investors in the coming years as 2011-2012 vintage funds begin divesting assets. We believe this capital dynamic, combined with declining property valuations, creates an attractive entry point. Finding value is relatively easy, but avoiding value "traps" is the tricky part. The market opportunity has shifted from development to a distressed acquisition focus, where the same asset that traded at a 9% cap rate three years ago is now trading 200-400 basis points higher. Lower leverage utilization in Brazil will limit the volume of distressed opportunities, but there is no shortage of cash-starved real estate companies looking to negotiate off-market deals to avoid reputational risk.

Figure 4: $USD / BRL FX AND PRICE OF OIL



Data Source: Federal Reserve Bank of St. Louis

Foreign currency exchange risk is magnified in certain markets such as Brazil, where the historic volatility of the local currency makes hedging strategies unavailable or prohibitively expensive. As shown in **Figure 4**, the Brazilian real (BRL) is currently hovering near its lowest valuation relative to the U.S. dollar in the past decade and since the inception of Brazil's modern currency plan in 1994. While we cannot prognosticate currency valuations going forward, there is some comfort in the current valuation relative to history. Further, most private equity fund structures provide a sort of "natural hedge" to FX rates given the periodic nature of cash flows. While the devaluation of the BRL provides purchasing power for U.S. dollar-based investors, we believe proper structuring with managers is crucial to ensure alignment of interests. In our view, managers should be more or less "currency agnostic," focusing on making good underlying real estate

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investments in their local markets. Thus, we believe incentive compensation structures should be calculated in the local currency, serving to ensure managers aren't paid for underperformance that may be "covered up" by beneficial currency movements over the fund's life.

We believe there is likely more pain to come and that the economic situation in Brazil may get worse before it gets better. For investors with a greater risk tolerance that can stomach some interim currency volatility, we think the real estate opportunity in Brazil is one of the few globally that may actually be able to achieve 20%+ returns in today's environment, without a heavy reliance on leverage. Importantly, these types of returns do not rely on overly rosy assumptions with respect to an economic rebound or growth in Brazil. Manager selection is crucial, however, and underwriting should be carefully scrutinized to ensure required returns are achievable without unrealistic growth expectations or cap rate compression.

The Role of Co-Investments as a Real Estate Portfolio Construction Tool

In recent years, private real estate investors have focused on access to co-investments as a tool to increase allocations to private real estate. Increasingly, both new and seasoned investors have targeted co-investments for some or all of the following reasons:

- *Increase total portfolio returns*
- *Reduce fee loads*
- *Increased control over real estate investments*
- *Quickly build exposure to private real estate*
- *Build strategic relationships with top-tier managers*
- *Gain complementary investment exposures*

While co-investments can provide an excellent diversifying element to *established* real estate portfolios, they are a fairly inefficient mechanism to build out real estate portfolios *on their own*. Investors seeking exposure to real estate primarily through co-investments bare themselves to higher risks than entry through more diversified vehicles. Among other things, concentration in a few assets increases risk that underperformance at any one asset has a more meaningful impact on portfolio performance. Although increased selectivity by limited partners can help reduce the potential risk of underperformance in a particular deal, concentration risk cannot be mitigated through careful underwriting. As experienced investors in real estate are aware, it is often the unforeseen risks that ultimately have an impact on returns in any particular deal.

A more nuanced concern relates to the quality of deal flow that a co-investor may see—i.e., potential adverse selection issues associated with which assets general partners offer to co-investors. An oft-touted argument is that if a particular investment is considered attractive to a manager, the manager should attempt to find a way to include as much of the deal as possible in its commingled fund. However, if a deal is less desirable, co-investments offer a way to reduce risks for the manager, at the expense of increased deal exposure to co-investors, while allowing the managers to build AUM. Our view is that adverse selection may rear its head in certain circumstances, but factors such as fund concentration limits and other portfolio construction considerations lead to attractive co-investment offerings as well. Regardless of one's view, everyone can agree that deal selection is especially critical.

Finally, we note that real estate co-investments are staff and resource-intensive. Due diligence timelines are compressed and deal flow is highly irregular. RVK has noted several investors having to pass on potentially attractive co-investment opportunities because they are not structured appropriately to execute on deals with short timeframes. Thus, in many instances some level of delegation is required at the staff-level in order for investors to participate in co-investments—a challenge for many committees. RVK can add value by leading or assisting in underwriting co-investment opportunities on behalf of capacity-constrained investors.

Overall, we believe co-investments can play an important role in portfolio construction and can reduce overall fee loads if structured appropriately, but the "jury is still out" on their ability to deliver sustainable outperformance. In order to achieve their goals, the vast majority of private real estate investors would be better off focusing their attention on reducing management fees and creating a better alignment of interests through creative incentive compensation structures rather than be enticed by the "co-investment carrot." However, for those investors that do have established real estate portfolios, we recommend co-investment strategies that can be good *add-on* investments for their portfolios and more broadly evaluated goals, focusing on deals where an investor wishes to take on a specific targeted exposure. As always, partner selection and judicious underwriting is key.

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