GLOBAL REAL ESTATE MARKET NEWSLETTER

NOVEMBER 2016

GLOBAL REAL ESTATE MARKET OVERVIEW

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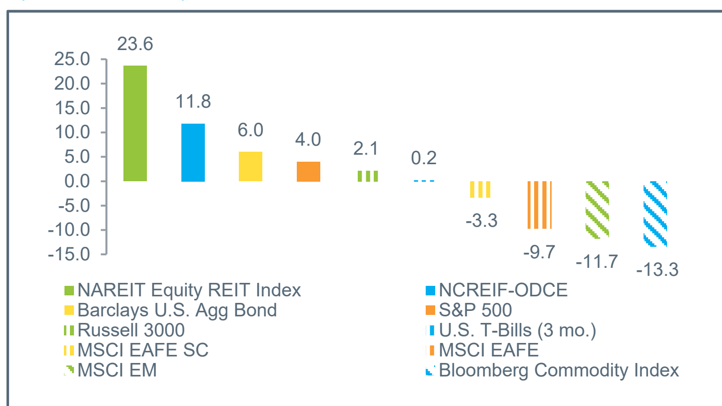
About RVK Real Estate

As the saying goes, "the more things change, the more they stay the same." The world continues to function despite recent volatility, with current concerns led by the uncertain long-term impact of Brexit on the global economy. Right on Brexit's heels are wildly chaotic political climates in major countries like the U.S., Brazil, and Turkey; a disturbingly pervasive global terrorism threat; Europe's ongoing immigration crisis; a curious trend toward negative interest rate policies in the developed world; and sudden and unpredictable swings in currency valuations. Despite these global headwinds (and others), as shown below in **Figure 1**, U.S. real estate continues to outperform other asset classes. With low (or negative) interest rates permeating throughout the world's economy, global investors continue to seek out real estate in a search for yield. The appetite for stabilized U.S. real estate is particularly persistent due to the relative perceived safety of the U.S. economy and the U.S. dollar. Fortunately, valuation increases continue to be backed by growing operating income, and absorption continues to outpace supply in most sectors. However, we are watching carefully for signs that valuations extend beyond those suggested by underlying fundamentals. **Figure 2** represents the growth in U.S. property prices with values now approximately 26% above prior cycle peak levels and 3% greater than year-end 2015 values. We believe real estate will remain attractive vis-à-vis other asset classes as long as global rates remain low and supply is in-balance, but it feels like the glory days of double-digit core real estate returns are coming to an end.

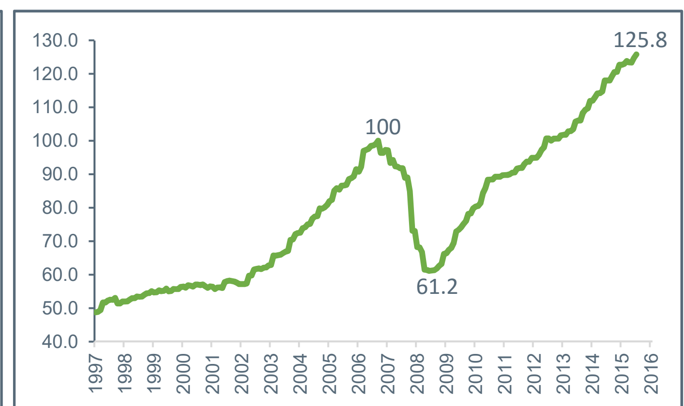
The prior issue of the RVK Global Real Estate Market Newsletter highlighted our contrarian view on current opportunities in Brazilian real estate and how co-investments should be considered as a portfolio construction tool rather than simply an alpha generator. In this issue we discuss a comparison between the "allocator" and "operator" model, showing that while each can play a meaningful role in an investor's portfolio, careful attention should be paid to the additional fee drag inherent to the allocator model to ensure investors are being compensated appropriately for the underlying property-level risk. We also address the recent surge in "core-plus" fundraising, attempting to determine what exactly "core-plus" risk means and how it should (or should not) be utilized in certain portfolios. 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 06/30/2016)



Data Source: NCREIF, Bloomberg

Figure 2: COMMERCIAL PROPERTY PRICE INDEX
(AS OF 6/30/2016. INDEXED TO 100 IN AUGUST 2007)



Data Source: Green Street Advisors

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CURRENT REAL ESTATE INSIGHTS AND OPPORTUNITIES

Allocators vs. Operators

Private real estate fund managers can generally be classified as either capital "allocators" or direct "operators." There are several differences between the models, but the primary differentiator lies with the level of in-house asset management capabilities. Operator managers generally have vertically-integrated asset management platforms capable of managing the fund's underlying properties on a daily basis. Operators' expertise is generally specialized, and thus strategies employed by operators are typically more narrowly-focused, targeting specific markets and/or property sectors where the manager has expertise. Investment vehicles managed by operator managers are typically smaller, as it is more difficult to grow operations and expand into new strategies while maintaining robust internal asset management teams.

Conversely, allocator managers primarily acquire properties through joint ventures with local or regional partners. They pursue broader investment strategies by allocating capital across a network of joint venture partners to execute property-level business plans and manage assets on a daily basis, with the fund manager's operational involvement often focused on budget formation and major leasing or capital decisions. This structure allows the allocator manager to invest across a variety of markets and property sectors to efficiently build larger and more diversified portfolios. This breadth, however, comes at a greater cost to investors, as joint venture partners receive additional fees and incentive compensation from the allocator in exchange for managing the asset. For some fund investors, the additional cost is worth the efficient diversification, but careful analysis is warranted to ensure the net return to the LP is still justified given the property-level risk.

Holding all else constant, investors with operator managers benefit from lower gross-to-net spreads by avoiding fees and "double promotes" paid to both the fund manager and the joint venture partner. **Figure 3** illustrates how this additional fee drag can lead to lower net returns for investors with the same property-level risk. Let us assume a $25 million investment in a given fund generates a 20% gross IRR and 2.9x multiple on invested capital ("MOIC") across the portfolio (which would require quite a bit of risk in the current environment). If an LP invests through an operator manager, it will only pay a management fee and promote to the operator, as

Figure 3: GROSS-TO-NET FEE SPREAD EXAMPLE

	Operator Fund	Allocator Fund
LP Fund Investment	$25 Million	$25 Million
Gross Property Portfolio Returns	20.0% IRR / 2.9x MOIC	20.0% IRR / 2.9x MOIC
JV Partner Fees	N/A	0.5%
JV Partner Preferred Return	N/A	12.0%
JV Partner Promote	N/A	15.0%
Returns Net of Partner Fees and Promote	20.0% IRR / 2.9x MOIC	17.9% IRR / 2.6x MOIC
Fund Management Fee	1.25%	1.5%
LP Preferred Return	8.0%	8.0%
Fund Manager Promote	20.0%	20.0%
Net Returns to Fund Investors	**16.4% IRR / 2.3x MOIC**	**14.2% IRR / 2.1x MOIC**
Operator Model Fee Savings	**$6.6 Million**	

Source: RVK; results above are hypothetical estimates and for illustrative purposes only

~ 220 bps of return and $6.6M saved through the "Operator" model

there is unlikely to be another partner in the deal since the operator has the ability to manage the asset internally. After paying typical market fees for a fund investment managed by an operator, the net returns to the LP would be approximately a 16.4% IRR and 2.3x MOIC. Now assume the same investment is made in the same portfolio generating a 20% gross IRR and 2.9x MOIC, but the investment is made through a fund managed by a capital allocator. The LP will pay a typical management fee and promote to the allocator manager, and then an additional management fee and promote is paid from the fund to the joint venture partner as compensation for managing the asset (albeit at different levels than is paid to the fund manager). In the example in **Figure 3**, the net returns to the LP would be approximately a 14.2% IRR and 2.1x MOIC: **220 basis points and $6.6 million lower than the LP would earn by investing in the exact same portfolio through the operator manager.**

That being said, investors should only focus on operator managers, right? Not necessarily. RVK generally prefers investing through operators when possible to (i) increase control over portfolio construction and (ii) reduce the gross-to-net fee spread, but we recognize the need for many investors to work with allocators to maximize diversification. Allocator managers still play an important role in achieving sufficient diversification and to avoid missing out on certain strategies or exposures. It is difficult to build and manage a diversified real estate portfolio

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exclusively investing through operators, and that strategy could lead to exposure gaps that can only be filled through certain allocator managers. It may also be prudent to invest with certain allocators to access important "knowledge capital" that can be gained through working with as many talented individuals as possible. Allocator managers tend to have larger pools of capital available and thus do larger deals, which can further complement the smaller transaction sizes typical of operator managers. Larger deal sizes may also lend itself to more co-investment opportunities, which may be suitable for certain investors' portfolios.

In summary, there is no "right or wrong" model for fund managers to utilize, but it is important for investors to understand the difference and analyze the tradeoffs appropriately prior to making a commitment. Investing directly through operator managers allows investors to choose their exposures more carefully and will generally lead to lower fee drag between the property-level return and the true net return to the investor. However, it is difficult to build portfolios through this method and in many cases allocator managers can provide complementary exposure and allow investors to diversify more efficiently. *Can the exposure be obtained elsewhere? Is the enhanced diversification worth the additional cost?* And perhaps most importantly, *am I being compensated appropriately on a net basis for the underlying property risk?* These are all critical questions that should be evaluated when navigating the "operator vs. allocator" landscape.

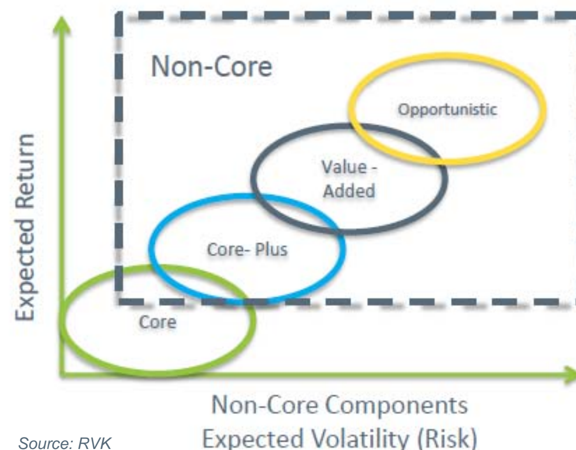
An Opportunity in the Proliferation of Core-Plus Funds?

For years, institutional real estate investors and fund managers had only three (3) traditional categories for classifying the risk/return of their private equity real estate strategies: **Core, Value-Add**, and **Opportunistic**. Increases in capital targeting real estate and a proliferation of new investment vehicles has now resulted in the lines between strategies becoming increasingly blurred.

This year can in many ways be called *The Year of Core-Plus Funds*, as the number of new offerings has increased significantly. According to a Bloomberg.com article on April 21, 2016 titled "Blackstone Weighs Opening Up Real Estate to Individual Investors," Blackstone's Chief Executive Stephen Schwarzman believes that Blackstone alone could have $100 billion of core-plus real estate assets under management within 10 years. The article states Blackstone has already raised over $12 billion in core-plus capital in a span of only two years, confirming the opportunistic giant's continued focus in this space. In addition, other large, established, traditionally core and opportunistic managers such as Invesco and Brookfield have also recently launched or announced plans to launch their own core-plus offerings.

So should investors consider including core-plus strategies as a distinct, fourth type of investment category in a real estate asset allocation plan? The answer depends upon an investor's individual risk tolerance and required investment return targets. In many ways, core-plus funds resemble core real estate funds, such as those that comprise the NCREIF-ODCE index, but in many other ways can resemble value-add, opportunistic, or even specialized sector-specific real estate funds. Further complicating matters is that there is no broadly accepted definition of a "core-plus" real estate fund, as "core-plus" tends to be more of a marketing tagline, rather than a specifically-defined category.

Figure 4: REAL ESTATE RISK-RETURN CATEGORIES



Source: RVK

RVK frequently counsels our clients that core-plus funds typically occupy a hybrid space somewhere between core and value-add real estate funds and that some funds may appear to be more "core-like" or "value-add-like" along that risk/return continuum. Core-plus funds typically invest in high quality real estate assets that offer an opportunity to add incremental value or return to core quality by "fixing a problem" associated with the real estate. Typical problems to be fixed include:

- Broken capital structure, either through excessive use of leverage, an undercapitalized owner, or both;
- Elevated vacancy (re-leasing opportunity); or
- A slightly "dated" building that needs capital improvements

As such, core-plus strategies generally offer slightly higher risk strategies than core real estate with the potential for slightly greater returns. To put that into

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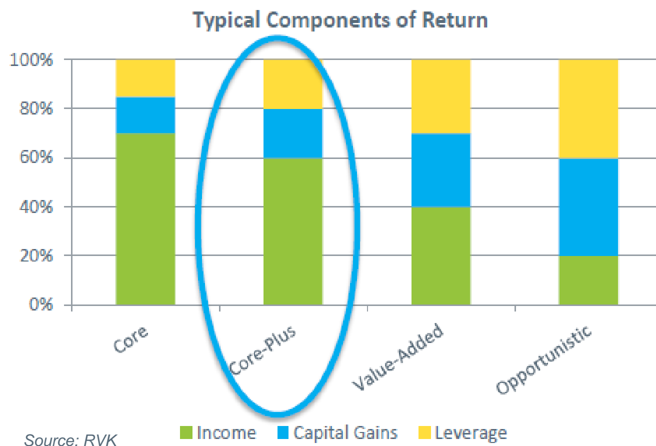
context, real estate returns comprise both income and appreciation components. Core-plus strategies, in general, have a greater return potential vis-à-vis core funds due to the combination of (i) income, (ii) capital gains, and (iii) greater utilization of leverage. As shown in **Figure 5**, typical core-plus real estate strategies rely more heavily than core strategies on value appreciation to meet return targets (typical core plus targets average 8-12% annualized gross IRR, depending on strategy, as compared to the typical 6-8% for core strategies).

Figure 5: COMPONENTS OF RETURN



Source: RVK

On balance, the proliferation of core-plus strategies over the past several years represent a net positive to the institutional investor. With more choices and options than ever before, investors have the opportunity to construct a portfolio that can focus on a wide variety of strategies, including U.S. widely diversified real estate, pan-Asian and European core-plus assets, funds that invest only in industrial properties, apartment-only strategies, and high street retail, to name a few. Additionally, with ever-compressing global yields and capitalization rates in core real estate, core-plus strategies offer investors another tool to construct an optimal portfolio for meeting required return targets. However, careful consideration must be taken to ensure a “core-plus” strategy is more than just core with greater leverage, and not just a value-add fund in disguise. Also, given how blurry the lines distinguishing core-plus and value-add strategies tend to be, investors must also be diligent regarding potential conflicts over deal allocations for managers that offer fund products across the risk spectrum.

RVK has assisted its clients in completing due diligence and making investments of over $1 billion in core-plus real estate strategies over the past two years. For further information or to discuss core-plus real estate strategies (or anything real estate-related for that matter!), contact us at RealEstate@RVKInc.com or +1 312.445.3100.

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