REAL ESTATE FUND MANAGER

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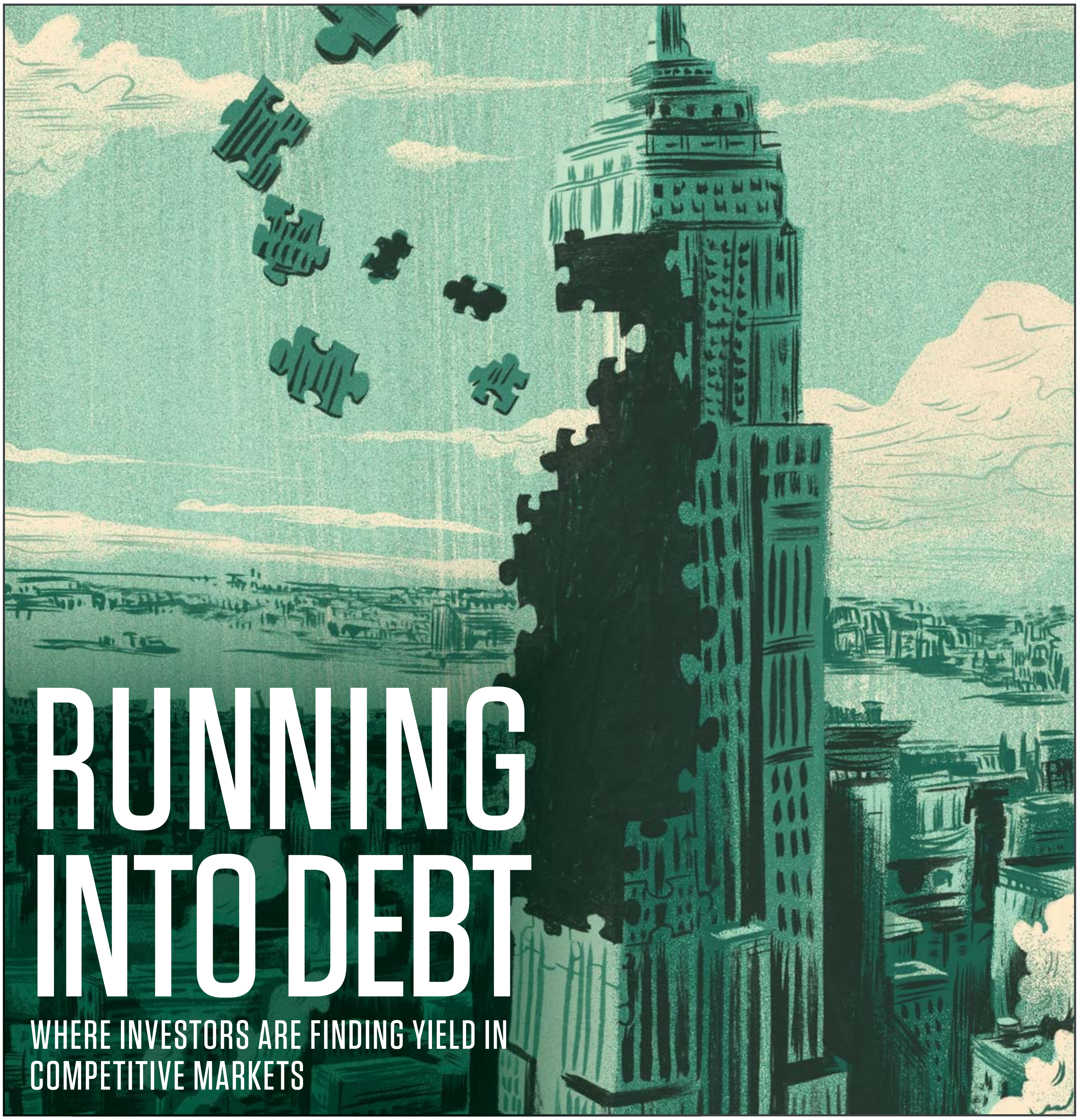

RUNNING INTO DEBT

WHERE INVESTORS ARE FINDING YIELD IN COMPETITIVE MARKETS

MAY 2015

WELCOME TO REAL ESTATE FUND MANAGER

Welcome to *Real Estate Fund Manager*, our new monthly magazine on the real estate private equity fund and investment management market. *Real Estate Fund Manager* will complement *Real Estate Finance & Investment*, which will continue to be published weekly and updated daily.

Our goal with *Real Estate Fund Manager* is to provide monthly perspective on the top news and trends affecting this segment of the market, with longer analysis pieces as well as first-day news about new fund launches. We're also going to be taking a deep dive into the operations and technology side of the business as part of our mandate to cover all parts and players in the market.

WE'RE ALSO GOING TO BE TAKING A DEEP DIVE INTO THE OPERATIONS AND TECHNOLOGY SIDE OF THE BUSINESS AS PART OF OUR MANDATE TO COVER ALL PARTS AND PLAYERS IN THE MARKET

As you will see, our first issue illustrates these principles. Jessica Pothering, our launch editor, has put together a really excellent look at how the hunt for yield has led to a rise in real estate debt funds while Sherry Hsieh, our reporter, takes a look at a student housing manager who has a contrarian view of the trend toward luxury for the undergraduate set.

We hope you enjoy the first issue of *Real Estate Fund Manager*. Please let us know what you think.

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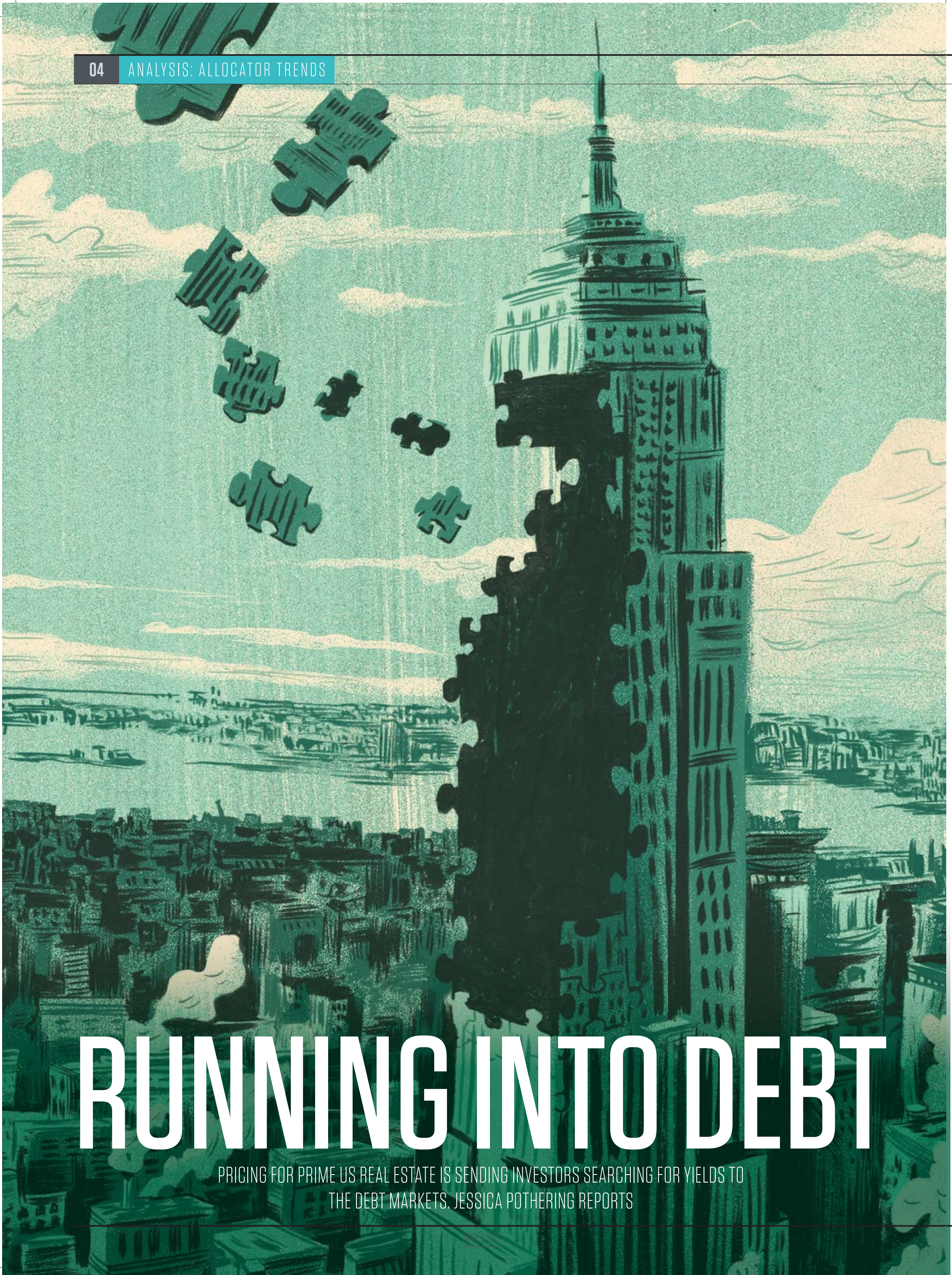
THIS ISSUE



RUNNING INTO DEBT

PRICING FOR PRIME US REAL ESTATE IS SENDING INVESTORS SEARCHING FOR YIELDS TO THE DEBT MARKETS. JESSICA POTHERING REPORTS

The search for yield in core markets is bringing more commercial real estate investors into debt as capital allocations to the sector rise, driving up property prices in most of the major markets.

Close to 50% of investors in North America, including pension funds, REITs, private equity funds and insurance companies, are looking to increase buying activity in 2015, according to a recent investor survey by global brokerage CBRE. Meanwhile, more than 60% of large institutional investors are considering increasing capital allocations to private real estate funds in 2015 even though these funds are already sitting on close to $220bn of uncalled capital globally, according to forecast data from alternative assets research firm Preqin. This is up $34bn from December 2013 and the majority – $113bn – is for North America-focused funds.

With this level of interest in real estate investment opportunity, in the US in particular, it is no wonder investment managers are expressing frustration in deploying capital and finding yield. "It's the fundamental issue of supply and demand. When there's a significant imbalance between available capital and investment opportunity, it creates a lot of pressure on investors," comments Brian McAuliffe, who leads CBRE's investment properties group in the US.

McAuliffe adds that it's the markets with the highest economic growth rates and limited real estate opportunities that become overpriced through aggressive bidding. New York. San Francisco. A handful of other top tier markets, including Washington D.C., Boston and Seattle. Cap rates for prime retail and multifamily assets in these markets averaged under 4.6% in the second half of 2014, while office averaged below 5.7%, according to another CBRE survey. These make it difficult for real estate funds to find desirable opportunities when they are targeting investor returns in the mid- to high-teens.

This shift has opened the doors for the debt funds. Last year, more than 20% of global investors investing in real estate via private funds had added debt as a strategic focus, compared to 13% in 2013, Preqin data shows. Most funds actively raising capital have focused on Europe, though roughly a third are still targeting US-based opportunities.

"Where the market is moving, some investors seem to prefer debt over equity because that is where pricing is. It provides an opportunity to place a significant amount of capital in core sectors in the US and Europe," observes Vickie Sharpe, head of client capital for TIAA Henderson Real Estate, a venture that formed from pension fund TIAA-CREF's acquisition of European investment advisor Henderson Global Investors. It has more than $22bn in real estate assets under management. The global investment manager, which caters to institutional clients, has a significant debt platform because of its ability to leverage TIAA's $27bn US-focused debt origination business. Its debt strategy focuses foremost on mezzanine lending in core markets.

Sharpe notes that demand for real estate debt investments is particularly strong from foreign investors, a number of whom have been exploring the strategy "almost to the exclusion of equity": "They want to invest in core markets like New York but they want to get in through the debt door," she said. This is because base rates for lending have remained low, meaning that private lenders can be competitive in the debt markets. This is attractive to investors against the low cap rate environment.

Public pension funds have are also demonstrating an increased focus on debt funds, alongside other real estate investment strategies. Industry experts note that the internal decision-making seems to be fueled from the fixed-income side of the business, which is searching for higher yields than what the historically low 10-year treasuries are able to offer. Their attraction to real estate debt is paying off for large private portfolio lenders like Mesa West Capital, which has garnered large contributions for past close-ended funds from pension such as the Wisconsin State Investment Board and the Kentucky Retirement Systems, according to data from Preqin.

Meanwhile Mesa West's open-ended Core Lending Fund has received contributions from the North Carolina Retirement System, the Indiana Public Retirement System, which made a $100m contribution in 2013, and more recently, the School Employees Retirement System of Ohio, which invested $75m this year.

Mesa West targets moderate returns compared to other funds with core and value-added strategies. Since its inception in 2004, the Los Angeles-based lender has focused on average originations of $50 to $80m, priced between 3-5% for first mortgages and 6-11% for mezza-

Top 10 Largest Private Equity Real Estate Debt Funds Currently in Market (as at 28 April 2015)

Fund	Manager	Vintage	Target Size (m)	Target Size (m USD)	Fundraising Status	Location Focus	Manager Country
CRE Senior 9	AXA Real Estate	2014	2,500 EUR	3,401	Second Close	Europe	France
AgFe Real Estate Senior Debt Floating Rate Fund	AgFe	2014	1,500 GBP	2,568	First Close	UK	UK
Hermes Real Estate Senior Debt Fund	Hermes Real Estate	2015	1,500 GBP	2,254	No Interim Close	UK	UK
ICG-Longbow UK Real Estate Debt Investments IV	ICG-Longbow	2015	750 GBP	1,127	No Interim Close	UK	UK
Pretium Mortgage Credit Partners	Pretium Partners	2014	1,000 USD	1,000	Fourth Close	US	US
TCI Real Estate Partners (I)	The Children's Investment Fund Management	2014	1,000 USD	1,000	Second Close	North America, West Europe	UK
Torchlight Debt Opportunity Fund V	Torchlight Investors	2015	1,000 USD	1,000	No Interim Close	US	US
UK Commercial Real Estate Debt Fund	Standard Life Investments Real Estate	2014	500 GBP	856	First Close	UK	UK
Brookfield Real Estate Finance IV	Brookfield Asset Management	2014	850 USD	850	No Interim Close	US	Canada
Related Real Estate Recovery Fund 2	Related Companies	2014	825 USD	825	No Interim Close	US	US

Source: Preqin

nine debt. Its success at putting capital to work for its investors has enabled it to build a capital base of more than $3.5bn and fueled a decision to raise a fourth closed-ended fund later this year, which will target a similar raise to its two previous funds: $650-750m (*see related story on page 10*).

A number of industry players believe opportunities for core lending in the US are narrowing, however, since the banking sector rebounded fairly quickly after the financial crisis. This is unlike Europe, where the financial sector continues to struggle, creating opportunities for private funds to fill the real estate lending void. Sharpe describes the aftermath of the financial crisis on Europe's banking sector as something akin to a paradigm shift and expects the opportunity in Europe will remain open for some time. Debt funds continuing to focus on the US, on the other hand, will increasingly trend towards value-added and opportunistic strategies.

"You don't see a lot of funds raised being raised to lend on core office in New York. The cost of raising and managing capital for private sponsors is likely higher than bank or insurance company lending, which means they are going to have a hard time being competitive on loan pricing," says John Ferguson, co-chair of Goodwin Procter's real estate private investment funds practice.

A number of debt fund managers still manage to find plenty of opportunity in New York, in spite of claims that the market is overly competitive and over-priced. These opportunities just happen to be a bit farther along the risk-spectrum. Institutional investors are willing to engage there, however. In CBRE's 2015 investor survey, 66% of investors reported their real estate strategies will concentrate on value-added and opportunistic strategies – up from 57% last year.

Private equity firms like Madison Realty Capital can speak to investors' increased risk appetite first hand. The middle-market manager recently announced a $145m first-close for a $600m fund targeting origination and acquisition of value-added and transitional debt and preferred equity real estate interests. A sizeable number of institutional investors have so far backed the fund.

MRC has been engaged in New York's debt space for 10 years and got its start making small loans – $5-25m – to real estate investors and developers who did not fit traditional lenders' profiles. The New York-based investment manager also acquires debt, invests equity and lends mezzanine financing and preferred equity, though its main focus now is senior lending. It originates 18-24 month loans between $5 and $100m at 8-12% interest then leverages the debt to get its returns in the high-teens, according to co-founder Josh Zegen.

Leveraging debt is of course a recognized strategy for boosting investor returns. It was also the major contributing factor in the collapse of the real estate markets in 2008. Zegen notes that MRC is cautious about how it approaches leverage compared to many industry players' who fell hard in the crash and even some other fund managers today.

"You see some funds leveraging two to four times their loan values to hit return targets, which means their unlevered targets aren't very high. We use no more than one-to-one leverage, most of the leverage we obtain is on an asset-by-asset basis, rather than cross-collateralizing an entire pool of assets, which is more risky," Zegen explains.

Other lenders like Pembrook Capital Management apply even less leverage to hit its targets. Stuart Boesky, CEO, says the investment firm is able to achieve returns in the low- to mid-teens while keeping its portfolio leverage below 40%. This kind of caution has kept institutional investors coming in the door since the firm launched in 2007 and will nudge it past the $1bn lending mark this year.

"A lot of investors have been burned by debt strategies that utilized significant amounts leverage at a time when the markets started losing liquidity," Boesky notes. He adds that the leverage Pembrook does use is match-funded, so the company is not borrowing short and lending long. Furthermore, while Pembrook has average lending rates of 5% on senior debt and 12-13% on mezzanine debt, it issues only floating-rate loans to avoid interest rate risk. The company also mitigates risk by focusing on markets where liquidity is strongest: primary markets like New York with the occasional top-end secondary market asset mixed in.

In turn, Pembrook has carved out a comfortable niche for itself as a middle-market fund manager focusing on $5m-50m loans to borrowers who, like MRC's, have difficultly securing a sufficient amount of financing from traditional lenders, particularly for development projects. Boesky and Zegen both agree that the reason for this has less to do with the risk profile of the projects and more with a shift in banks' lending habits over the past 24 months.

"It took awhile for banks to understand new regulatory requirements and now they are becoming more conservative in issuing construction loans in particular," Boesky explains. This is because banks are required to set aside 150% of the capital used to finance "highly volatile assets," which may include real estate developments. Whereas they may have financed 65% of a multifamily project's costs two years ago,

Top 10 Largest Private Equity Real Estate Debt Funds Closed Since the Start of 2015 (as at 28 April 2015)

Fund	Manager	Vintage	Final Size (m)	Final Size (m USD)	Location Focus	Manager Country
Pimco Bravo Fund II	PIMCO	2013	5,500 USD	5,500	US, Europe	US
Broad Street Real Estate Credit Partners II	Goldman Sachs Merchant Banking Division	2014	2,400 USD	2,400	US, West Europe	US
Kildare European Partners I	Kildare Partners	2013	2,000 USD	2,000	West Europe	UK
AgFe Senior Debt Fixed Rate Fund	AgFe	2014	1,000 GBP	1,677	UK	UK
M&G Real Estate Debt Fund III	M&G Investments	2014	750 GBP	1,248	West Europe	UK
Colony Distressed Credit & Special Situations Fund III	Colony Capital	2013	1,200 USD	1,200	US, West Europe	US
Oaktree Real Estate Debt Fund	Oaktree Capital Management	2013	1,010 USD	1,010	North America, Europe, Asia	US
LaSalle Real Estate Debt Strategies II	LaSalle Investment Management	2013	600 GBP	989	Germany, UK	US
European Real Estate Debt Fund II	DRC Capital	2013	485 GBP	817	West Europe	UK
Prime Finance Partners IV	Prime Finance Partners	2014	800 USD	800	US	US

Source: Preqin

today these rates are coming down to 50-55%, leaving even established developers in core markets in search of other lending sources to cover their project costs.

The executives from both Pembrook and Madison Realty Capital say they have seen activity in their senior lending business tick up, which appears to be a consistent trend among other private funds, according to Dan Lisser, senior VP with commercial real estate finance company Walker & Dunlop. Lisser has noticed that private lenders are leading more of the debt structuring on institutional properties looking for financing between $50m and $100m. They will originate the full note and then sell off the senior piece, often to more traditional lenders.

"Borrowers prefer the convenience of only dealing with one lender and it allows [private lenders] to create their own leverage while clipping higher returns on the senior note," he explains. Most of these cases are higher-leverage deals, north of 65% with some reaching 85% leverage from borrowers who do not want to bring in additional equity partners. Most lenders will only apply this strategy if they have a buyer for the senior debt lined up already, otherwise it is too risky, Lisser adds. "It would be worrisome but the underwriting environment is so tough."

With the progression of debt investment strategies and successful fund-raising by value-added and opportunistic shops, the sentiment from institutional investors appears to be that debt is a safe bet for garnering equity-like returns in markets where cap rates are heavily compressed. Yet this does not mean that investors are shifting from core strategies. CBRE's investor survey reveals that 20% of investors are increasing their focus on core equity investments for 2015 compared to 17% in 2014.

CBRE's McAuliffe points out that institutional investors are trying to maintain balanced portfolios, so while they may be increasingly looking down the risk spectrum for higher returns, they are still focused on stabilized, cash-flow generating properties in liquid markets: "Often these highly competitive situations stem from investors trying to satisfy portfolio construction. This has a material impact on pricing because their objectives go beyond hitting a specific return on a specific asset," he said.

Not all traditional core equity funds believe stories of pricing wars or premium trades like last year's $2bn sale of New York's Waldorf-Astoria hotel tell the full picture of real estate opportunity in the core markets.

"A lot of investors are getting nervous about whether the core markets are fully priced. Our conclusion is that on a real basis, core markets still represent good, balanced value," says Simon Treacy, global CIO and and head of US equity for BlackRock Real Estate, which holds $23bn in

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SIMON TREACY, BLACKROCK

assets under management globally, more than $4bn of which are based in core US markets. According to the firm's data, the only major US market that has approached peak 2007 pricing on a real basis is San Francisco. New York, meanwhile, is still 7% below the peak on a nominal basis and 15% below on a real basis.

"Some investors might work with different data and there is no way they are going to look at San Francisco. But we have even seen opportunities in San Francisco with comfortable pricing levels," Treacy adds. How the firms underwrites the deals it looks into, factoring in future rent growth over a seven to eight year investment timeline, and building in annual increases in net operating income, could potentially tack 20 or 30 basis points onto real cap rates over super-low rates that make headlines.

More disconcerting than the hype around primary market competition is investors' divergence to secondary markets. Treacy says that while the industry overall is being cautious and there are a lot of cross-checks happening, anxiety about a pricing cliff threatens to push investors back into markets that may become once again illiquid: "The trap is that people begin chasing yields in secondary markets that are not buoyed by strong economics. They get by with a couple of years of higher yields only."

He concludes that investors are still highly discerning of fund managers' strategies and are wary of those that are hinting at a style-drift. This seems to hold up in fundraising statistics, which show that regardless of the risk strategy, focused fund managers like the BlackRocks, the TH Real Estates, the Madison Realty Capitals, Mesa Wests and Pembrooks, succeed in winning over institutional investors among the hundreds of funds currently trying to raise capital.

He concludes: "Investors interested in core markets in particular want a manager who is disciplined." ◘

Jessica Pothering
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