Private Equity Real Estate Funds: An Institutional Perspective

January 15, 2008
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Private Equity Real Estate Funds:
An Institutional Perspective

by Andre Kuzmicki and Daniel Simunac

Introduction
The importance of private equity real estate (“PERE”) funds has been growing dramatically in recent years. Through the first half of 2007, PERE funds continued to expand in terms of their number and average size. Although several high-profile takeovers of large publicly-traded real estate entities have underscored the influence of PERE funds, relatively little is known about them. Questions which have arisen regarding such funds include: what are PERE funds and what distinguishes them from other types of real estate investment vehicles? Why have they attracted so much investment capital? And, what are their prospects in a post credit crunch environment? These are among the issues we address in this paper. In addition, our research discusses why and how Canadian pension funds in particular, are making use of PERE fund vehicles within their investment portfolios.

We begin by noting that, until recently, there has been little research on PERE funds in Canada or elsewhere. This may be because their activity has not historically constituted a large portion of the overall real estate investment universe. It may also reflect a lack of available data because, as predominantly privately-held entities, PERE funds are not required to disclose details regarding their activities nor financial performance. Our findings are based on: (a) interviews with several PERE fund managers (both from the U.S. and Canada); (b) interviews with executives from Canada’s largest pension funds; (c) data compiled by Private Equity Intelligence Ltd., a British-based, global PERE fund database; and (d) relevant academic and popular publications.

Many industry observers believe that the proliferation of PERE funds can be explained by the availability of cheap debt. The advantage of inexpensive financing for leveraged buyers is clear. However, this does not explain why presumably prudent institutions are by far the largest category of investors in PERE funds. Certainly strong institutional demand for real estate product (what has been dubbed a “wall of capital”) is causing investors to look beyond traditional investment strategies. But perhaps a more important and permanent change, which might be described as “evolutionary”, is taking place.
Investors have been adopting increasingly active management approaches to real estate investing and portfolio management. It was not that long ago such investors viewed the need for industry-specific experience, specialized skills, and local market knowledge as impediments to real estate investing. Today, they view such attributes (either in-house or procured externally) as opportunities to: (a) expand into new markets; (b) diversify their holdings; and (c) enhance overall investment returns.

This change is particularly evident amongst the largest Canadian pension funds, most of which have substantial exposure to PERE funds. In general, their commitment to PERE funds reflects an appreciation of the role that management plays in the performance of real estate portfolios. This role consists of two parts: (a) identifying investment trends and opportunities at a macro level, and (b) implementing corresponding investment strategies at a micro level. Management in this context can be defined as human capital, which possesses the creative vision, motivation and expertise, to conceive and successfully execute investment strategies.

**Private Equity and Real Estate: A Perfect Match**

As the name implies, private equity real estate is a hybrid of the “private equity” and “real estate” asset classes. In general, private equity investments encompass various forms of strategies for investing in businesses or stand-alone assets, where ownership is neither widely-held nor traded on public stock exchanges. While traditional private equity consists of direct ownership by investors, private equity funds relate to indirect ownership by investors through a third-party fund manager. In most cases, the investors themselves are private entities (i.e. pension funds).

Aside from real estate oriented-funds, types of private equity funds include those which invest in privately-held companies with growth potential (i.e. venture capital funds), and those taking mature public companies private (i.e. leveraged buyout, or “LBO” funds), among others. Many funds employ leverage as a means to enhance returns but leverage is typically not the exclusive investment strategy, if used at all (i.e. venture capital investments are not able to obtain financing during early stages of growth). Leverage should be viewed as a way to improve returns on an already good investment strategy.

Not to be confused with hedge funds, private equity funds typically invest with the intent of owning and managing their investments for several years or more. The primary objective of private equity funds is to create or enhance value through “hands-on” management at the operational level.

Private equity is attracted to real estate because many of its inherent attributes fit well with strategies employed by most private equity firms. This may in part explain why PERE funds have grown from being a niche sector within the private equity asset class, to being second only to LBO funds in terms of capital raised over recent years. Such attributes include:

- **Ownership and Control** – Direct ownership allows for greater control over the direction and destiny of investments. While the discretion on a publicly-traded security is limited to “when to buy” and “when to sell”, direct ownership adds “management” to this equation. Active management allows owners of investments to pursue strategies which can improve returns beyond those achieved as a result of general market forces, at both the asset and entity level.
• **Wealth Creation** – In certain circumstances, real estate assets present opportunities for knowledgeable managers to add value by improving the physical, financial, and/or operational characteristics of a property.\(^4\) Value-add strategies, if successfully executed, can yield a property value which is substantially higher than the sum of the acquisition cost and additional capital invested, within a relatively short period of time. Generally value-add strategies involve turning underperforming or non-institutional quality assets into stable, cash flowing, institutional quality assets.

• **Subdividable Interests**– Real estate interests can be subdivided in a multitude of ways. For example, whole portfolios can be bought and sold individually or in any combination of clusters (i.e. by geographic location or property type). Individual properties may be subdivided, financed, and/or leased. The success of these strategies lies in a fund manager’s ability to identify which assets, structures, and potential buyers, when combined, yield the highest aggregate value. Compared to other types of non asset-based investments (i.e. those which have a strong reliance on brand equity, goodwill, trademarks, among other intangible assets), real estate can be broken-up into separate pieces more easily, with each component potentially more valuable than before.

• **Platform Value** – Just as assets can be subdivided easily, they can also be combined to create more profitable portfolios. Recognizing that real estate is management-intensive, and that different market segments require different skill sets, PERE funds have evolved their strategies to place an increased focus on the value of operating platforms. Building or acquiring an operating platform and using the economies of scale that it provides, allows accretive acquisitions of assets and/or development of new assets.

• **Financeability** – Because of real estate’s inherent characteristic as a stable and predictable generator of cash flow, it is financeable on more favourable terms than other types of transactions. For example, most recent non-real estate LBOs have been able to obtain debt levels ranging between 6-8x debt multiples (i.e. debt divided by cash flow). However, it is not uncommon for many types of real estate transactions (buysouts or otherwise) to obtain debt multiples in the 10-12x range. Even though its cash flow may be “lumpy” at times, real estate is highly financeable because it is tangible.\(^5\) As such, it serves as excellent collateral which lenders are able to underwrite to relatively higher debt levels, longer terms, and lower costs of capital.

• **Dual Market Liquidity** – Real estate has the advantage of being tradable in both public and private markets. In certain circumstances this provides PERE funds an opportunity to arbitrage between the two markets by taking undervalued public companies private. These parallel markets also provide PERE funds two separate exit strategies: (a) selling assets to the private market; or (b) converting an accumulated portfolio of assets into a public entity via an initial public offering (“IPO”).

**Fund Structure**

The term “PERE fund” generally refers to private equity funds which have a primary focus on real estate in its various forms. Notwithstanding recent attention surrounding the buyout of public entities, it should be noted that the majority of activity by PERE funds is directed at the acquisition/development of privately-held real estate at the asset level. It is common to apply the term to closed-end, limited life funds which pursue higher-risk investment strategies, though some observers include open-ended, “core” type funds as well (the focus of this paper is on the type of funds commonly referred to as “value-add” and “opportunistic”). Figure 1 provides summaries of the most common PERE fund types.
The universe of PERE funds is varied: from funds which acquire, manage and dispose of properties on an asset-by-asset basis, to those which acquire and re-structure whole entities; and from those which provide high-yield mezzanine financing, to those which acquire debt at distressed valuations. Strategies of PERE funds are also diverse and unique for each individual fund. For instance, while some have a local focus, others have a global reach; and while some are tightly-scripted, others are highly flexible. One of the particular strengths of the PERE fund format is its malleability, and the ability of fund managers to create new funds in response to emerging opportunities, which is an advantage they have over other investment vehicles.
In contrast to its strategic flexibility, the PERE fund model consists of a well-defined structure similar to that used by other types of private equity funds. The structure assists in (a) placing a focus on performance; (b) incentivizing the fund manager; and (c) aligning the interests of the fund manager with the interests of the investors. Components of the structure include:

- **Legal Form** – PERE funds usually take the form of limited partnerships. The funds are managed by a general partner (also known as the “sponsor”). Investors are referred to as “limited partners”. The funds are structured as closed-end, “blind pools” of capital, where investors commit a dollar amount to the fund, and the general partner has discretion (within the limitations of the offering memorandum) to invest such capital on their behalf. Limited partners provide their capital when called upon by the general partner (i.e. when suitable investments have been identified).7

- **General Partner** – The general partner defines the investment strategy, raises the capital, sources deal flow and is responsible for the operations and management of the fund. In most cases, the general partner is precluded from forming new funds until the capital committed to a current fund has been substantially deployed. This provides some assurance to limited partners that the general partner in not distracted, and concentrates on current fund activities.

- **Limited Partners** – Investment capital is raised from qualified investors, including: (a) pension funds, private foundations, and endowment funds; and (b) high-net worth individuals.8 Typically there are only a limited number of investors within any given fund.

- **General Partner Equity** – Sponsors typically invest as limited partners in each fund that they manage. The percentage contributed by the general partners ranges from 3-10% (or more) of a total fund’s size (their proportion typically increases as the size of the fund increases).9 In some cases, senior employees of the general partner who are involved in managing a fund will also invest as limited partners. These investments put sponsor’s equity at equal risk alongside their investors, which assists in aligning interests of the sponsors (and their employees) with those of their investors.

- **Limited Life Vehicles** – A fund’s expected life cycle is determined at the time of its creation. This typically ranges from three to eight years, plus up to two years of extension options, and includes the investing and harvesting stages.10 The relatively short investment timeline imparts discipline in the acquisition, management, and disposition processes by the fund manager and provides a defined liquidity horizon for investors.

- **Leverage** – The benefit of leverage is that it increases buying power, while amplifying investment returns. Leverage also increases risk because it magnifies negative returns if investments are poorly underwritten or executed, and/or market conditions deteriorate.

- **Management Fee** – From the time of inception, sponsors typically receive a management fee of between 1-2%, calculated based on the total committed capital to the fund, reducing to 1-2% of invested capital after the commitment period has closed (usually the first half of a fund’s life). The management fee provides for a certain amount of regular income to the sponsor to cover the fund’s operating costs and administrative expenses.

- **Incentive-Based Compensation** – The primary means of encouraging the sponsor to generate the highest returns possible is through the “promote” fee (also known as “carried interest”). While variations exist, a typical promote structure provides the sponsor with a 20% profit participation of either: (a) all the profits of the fund (as long as the limited partners have received at least their specified preferred return); or (b) only those profits in excess of the investor’s preferred return. The preferred return, also known as the “hurdle rate”, typically ranges between 8-10%, and may range as high as 15% for some opportunistic funds. The promote structure creates a very strong incentive to make money, thus further aligning the interests of fund managers with those of their investors.
Origins and Evolution

PERE funds derive from the LBO fund model which first became prevalent in the U.S. in the late 1970s. In those days there were few opportunities for such funds in real estate because owners and developers had easy access to inexpensive, high-ratio, non-recourse debt. However, the real estate market collapse of the late 1980s and early 1990s, led banks and other traditional real estate lenders to largely withdraw from the industry.

This investment climate created a unique opportunity for certain investors to acquire quality assets at significant discounts to replacement cost. So long as a buyer had the means to assume the existing debt obligations on a property, they required little or no equity to acquire it. The LBO fund model was adapted for this purpose and the funds that followed became known as “opportunity” funds. Opportunity funds of this period played an integral role in the recovery of the real estate investment market into the mid-1990s. Several funds exited their accumulated holdings through IPOs, and established some of the largest players in the real estate investment trust (“REIT”) industry today. Most notably, four funds formed in the early-1990s by Sam Zell, together with Merrill Lynch, were eventually merged into what became known as Equity Office Properties Trust in an IPO in 1997. At the time, and up until recently, Equity Office was the largest REIT in the U.S., owning 543 properties across the country.

PERE funds continue to shape industry trends. Where originally opportunity funds functioned as scavengers, acquiring distressed properties, loans, and companies (hence the origins of the term “vulture fund”), today they have broadened their range of investment activity to include new development, lending, and international investing. In many cases they are the highest bidders in non-distressed property sale auctions. Because they are not as sensitive to interim performance, where PERE funds see an opportunity to create or unlock value, they are able to acquire assets at higher valuations and/or assume higher levels of debt. In this regard, PERE funds fill a “value gap” in property markets, making them more efficient.

Capital Flows

While the global economy has experienced a sustained period of low inflation and fixed-income returns, pension funds in developed nations are contending with growing long-term liabilities resulting from an aging population. Combined, these factors have contributed to increasing capital allocations to real estate as an alternative to traditional fixed-income investments. In addition, as a result of lower prospective returns due to cap rate compression, investors have sought greater returns by moving further out along the risk/return spectrum.
Figure 2 shows the amount of capital that PERE funds have raised globally between 2002 and 2007, as well as the distribution amongst the four main fund types as tracked by Private Equity Intelligence. As can be seen from the graph, overall capital directed towards PERE fund investments increased roughly seven-fold between 2002 and 2006 (the number of funds raised in each year is shown above each bar). Despite a slowdown in fund raising in the second half of 2007 (due to global liquidity issues), we estimate 2006 levels will again be achieved. The trend towards higher return strategies is reflected in the proportion of capital directed at value-add and opportunistic funds, while the allocations to core–plus and mezzanine funds have grown at a more gradual pace.

![Figure 2 - PERE Fund Capital Raised by Fund Type (USD$ Billions)](image)

While the U.S. is the largest and most developed property market in the world, and the majority of all PERE firms are headquartered there, their activity is expanding beyond its borders. Several of the larger, more established firms have created international funds to take advantage of the growth and “institutionalization” of real estate markets around the world. Figure 3 shows the distribution of capital raised by target geographic market. Increased focus on Europe is in part associated with the emergence of REIT legislation. Investment in the “Rest of the World” relates primarily to growth opportunities in emerging markets including, China, India, Brazil and Russia, among others.

![Figure 3 - PERE Fund Raises by Targeted Geographic Region (USD$ Billions)](image)
Performance

Because the objective of PERE funds is to maximize total return over a fund’s life, the standard for measuring performance is the internal rate of return (“IRR”). Comparing performance among PERE funds is difficult and imprecise as no industry benchmark exists. In addition, public disclosure is limited such that the data for most funds is simply not available. As a result, PERE funds are typically evaluated using internal benchmarks, by comparing the actual IRRs received by limited partners to the original targeted projection. IRRs are calculated net of management fees and the fund manager’s promote. IRR figures for funds which have not been fully realized (i.e. exited), are calculated by ascribing an interim valuation on the balance of the fund’s portfolio. Though limited, the available data does provide useful evidence of the performance of PERE funds over the last decade.

Figure 4 presents median net returns for all types of PERE funds with vintage years ranging from 1995 to 2004. The data for all funds is combined because of the limited sample size for certain years. Excluding the high and low outliers, the returns range between approximately 12% and 22%, with a low of 7.8% for the 2002 vintage median fund, and a high of 26.2% for the 1997 vintage fund. The results suggest that the typical fund performed reasonably well during this period, regardless of the year in which it was closed.
Figure 5 compares the median returns for the same sample of funds to the first-quartile, third-quartile, minimum, and maximum returns during the same period. The returns for first and third quartile funds range between 4.7% for the 1997 vintage third-quartile fund, and 32.2% for the 2004 vintage first-quartile fund. This wide dispersion is a function of both the: (a) vintage year, and (b) success of certain fund’s abilities to select good strategies and execute them properly. The impact of these factors is more dramatically illustrated by comparing the minimum (−28.2%) and maximum (80.4%) returns achieved by the best and worst funds during this period.

Figure 6 illustrates that median net returns for funds with vintages between 1996 and 2004 have been generally consistent both with investor expectations, and the relative positions of each fund type along the risk/return spectrum (as outlined in Figure 1). Returns by the four major fund types are as follows: core-plus (10.9%), mezzanine (14.2%), value-add (16.9%) and opportunistic (17.4%).
Figure 7 compares the performance of PERE funds against non–real estate private equity funds between 1997 and 2004. The data reveals that PERE funds have outperformed all other private equity fund types throughout this period. During this time, PERE funds have also recorded the lowest standard deviation of performance among all such private equity funds. It is worth comparing these patterns of return to the performance by Blackstone’s group of specialty funds (including both LBO and real estate, among others). In its publicly disclosed IPO prospectus filed in early 2007, The Blackstone Group (the largest private equity firm in the world) reported that its real estate funds outperformed all other types of funds within its portfolio since 1992. It should be noted that the strong performance of all PERE funds can in part be attributed to cap rate compression driven by strong capital flows to real estate over the last few years.

![Figure 7 - PERE Fund IRRs vs. All Other Private Equity Fund Types (Vintage Years: 1997-2004)](image)

Source: Private Equity Intelligence

Figure 8 illustrates that both the number of PERE funds raised and their average size has consistently risen since 2002. The largest PERE funds, which have been raised by the most established firms, have come to be known as “mega funds” (defined as those PERE funds with over $5 billion in investment capital to deploy). Examples of these include Morgan Stanley Real Estate Fund VI International ($8 billion) and Blackstone Real Estate Partner VI ($10 billion), both of which were closed in the second half of 2007.

![Figure 8 - Average PERE Fund Size by Year Raised (USD$ Millions)](image)

Source: Private Equity Intelligence
A 2005 study by Steve Kaplan and Antoinette Schoar, argues that managers of better performing private equity funds are successful at raising follow-on funds, and that such funds tend to be larger than prior funds. Our interviewees confirmed that this bias also applies for PERE funds. Investors are more inclined to invest with managers who possess proven track records, than those who do not, and investors in successful funds tend to re-invest in follow-on funds. Accordingly, the strong relative performance achieved by PERE funds over the last decade is a factor in explaining capital flows to these funds.

Figure 9 illustrates that larger PERE funds have generated higher net returns between 1996 and 2004. This is consistent with the thesis that larger funds are sponsored by fund managers with proven track records. To the extent that past performance is an indicator of future performance, it may be inferred that larger funds have a higher probability of achieving a better return than newer, smaller-sized funds (all other things being equal).

![Figure 9 - Median IRR by PERE Fund Size](image)

**Risk and Risk Mitigation**

The majority of PERE funds employ strategies which revolve around value-add and opportunistic investments. Investors expect such risk-oriented funds to produce relatively higher returns. But what does “risk” really mean, and how can such risk be mitigated?

A 2003 study by Peter Linneman and Deborah Moy illustrates how the risk/return profiles of value-add and opportunistic assets differ from those of core assets. In their study, the authors present a number of investment strategies for the same quality of asset, including three classified as “core”, “value-add”, and “opportunistic”, respectively. The core asset is unlevered, fully leased and purchased at its stabilized value. The core-plus asset is identical to the core asset, with the exception that it is levered to 65%. The opportunistic asset is also identical to the core asset, except that it is under-leased and purchased at a discount to stabilized value. The opportunistic asset is levered to 70%. Using a simplified 7-year cash flow model, the authors compare the performance of the three assets over time and under different market conditions (strong, base case, weak, and disaster).
The study finds that, so long as the lease-up assumptions are met, the opportunistic asset outperforms the core-plus asset in each market scenario. On an absolute return basis, the opportunistic asset also outperforms the core asset in every market scenario, except in the event of a disastrous market downturn. This may surprise those who assume that higher loan-to-value ratios expose opportunistic investments to increased market risk. The explanation lies in the assumed discount to stabilized value built into the opportunistic asset’s purchase price. In effect, the assumed discount provides some downside protection against market risk – the deeper the discount, the greater the downside protection.

The pricing of the opportunistic asset is one of the two most critical elements in managing its investment risk. The other of course, is managing the “stabilization” risk. The study produces a wide range of outcomes dependent on the assumptions regarding the discount built into the: (a) purchase price; and (b) lease-up performance of the opportunistic asset. The sensitivity of the model to these assumptions demonstrates the importance of correct underwriting and timely execution, particularly if market conditions deteriorate.

We suggest that the importance of underwriting and execution is true at both the asset and entity levels of value-add and opportunistic investments. While the rationale most often cited in support of opportunistic investing is higher return, there is also a risk management rationale. This may seem counterintuitive, however the return premium built into the acquisition cost of such investments acts as a cushion against market downturns, and partially offsets the increased risk attributable to leverage. The key is having a fund manager with the: (a) vision to recognize the opportunity; (b) skills to price it appropriately; and (c) ability to execute the value creation component successfully.

**A Case Study in Unlocking Value: Blackstone’s Acquisition of Equity Office**

To demonstrate the interaction of vision, pricing and execution, we use the $39 billion acquisition of Equity Office made by Blackstone in early 2007. Ironically, Blackstone’s strategy to create value involves taking a “deconstructivist” approach compared to Zell/Merrill’s “consolidation” approach when they formed Equity Office a decade ago.

Although acquiring Equity Office assets at an assumed 5.5% cap rate (below the cost of debt at the time), and applying assumed leverage in excess of 70%, there are strong indications that the transaction may not have been as risky as many industry observers first believed. While its strategy has not yet been fully realized, a number of Blackstone’s actions to date support this view:

- Despite being in a bidding war with another formidable buyer, and paying a 14% premium to Equity Office’s prior trading price, Blackstone upped its purchase price only up to a level where the increase could be offset by pre-selling many of the assets to secondary buyers. In doing so, it mitigated the risk of overpaying for the portfolio.
- Within the first six months of closing on the acquisition, Blackstone had already disposed of more than 50% of the company’s assets to local buyers on a regional basis achieving record prices. Such buyers viewed these assets as strategically important to their portfolios, and accordingly were the highest bidders for such properties.
- Having sold most of these assets accretively, as of Fall 2007, Blackstone had already repaid roughly 70% of the original $39 billion purchase price. Using the proceeds of such sales, it has since lowered its debt ratio, repaid a significant amount of higher yielding mezzanine debt, and lowered its overall carrying costs.
• With roughly half of the portfolio still to be sold, the probability of loss has been dramatically diminished. Conversely, the probability for significant returns is very high, even if remaining assets were to be sold near their par value.

• As Blackstone owns significant office properties through its 2006 acquisitions of both CarrAmerica Realty Corp. ($5.6 billion) and 50% of Trizec Properties ($8.9 billion), it already has a presence in certain markets which it can leverage to optimize asset performance.28

• Owning properties through these three separate entities Blackstone may choose to consolidate their office properties at some point and take the combined entity public (even without consolidating assets, the residual assets of Equity Office are expected to be sufficient for an IPO). Depending on timing and market conditions, this could represent an attractive alternative to a private market exit.

While a number of industry observers question why Sam Zell (Equity Office’s CEO) didn’t have the vision to pursue an asset-by-asset sale strategy of Equity Office’s holdings, such a strategy would not have been achievable as a public entity. The process of: (a) selling assets, (b) paying out ongoing and special distributions, (c) buying back shares, (d) managing market expectations, and (e) winding up the company over a span of a few years, would have been cumbersome and risky. The Blackstone acquisition reveals how value can be extracted from a portfolio of assets by changing its ownership structure from public to private, which allowed its new owners to pursue strategies more opportunistically. That is not to say that one structure is better than another, but that different structures may be better suited depending on the assets themselves, or the capital markets environment.

Private Equity Real Estate Activity in Canada

Over the last decade, Canadian pension funds and their advisors have assumed a dominant role within the domestic real estate industry. Total real estate equity investment by Canadian pension funds has grown more than five-fold since 1997, reaching $64.3 billion by the end of 2006, with this figure expected to be higher for 2007.29 Of note is the fact that institutional exposure is concentrated amongst the largest half dozen or so pension funds. The pension fund exposure to real estate dwarfs total equity market capitalization of Canadian-based, publicly-traded companies (REITs and non-REITs combined) of $38.6 billion as of the end of 2007.30

A key issue for the leading pension funds has been securing investment and operational capabilities required to manage risk and exploit opportunities. Several of the pension funds took advantage of weak public market valuations in the early 2000s and privatized some of the most prominent public real estate operating companies in the country at the time. This was an important milestone in the evolution of real estate as an investment asset class in Canada, because it signaled that: (a) institutional money managers had recognized the value of specialized real estate management; and (b) they intended to continue to grow their real estate exposure over the long-term through the use of such platforms.

Other pension funds have elected to execute their strategies through advisory firms and/or co-investment programs with strategic partners. Regardless of the approach, investors are sensitive to the impact that management can make on investment results. They are focused on establishing relationships with managers who can assist them in the pursuit of their real estate allocation objectives. The search for execution capability underlies the interest in PERE funds by Canadian institutional investors.
PERE funds are not new to Canadian institutional investors. In fact, the largest pension funds have been investing in PERE vehicles since the early 1990s (predominantly in U.S.-based funds). Based on interviews with many of these investors, we estimate their combined current PERE fund holdings range between 5% and 10% of their total real estate exposure. The motivating factor for investment in these funds has been strategic and related to the need to grow and diversify institutional real estate portfolios into global markets. In many cases, the PERE fund vehicles have been used as an entry strategy into new markets. A complementary by-product is return, commensurate with the risk associated with such investments.

The universe of PERE funds sponsored by Canadian-based fund managers is small compared to the U.S. and global market as a whole. The limited number of domestically-based funds reflects the: (a) relative size of the Canadian real estate investment market; and (b) dominance by the largest pension funds whose assets trade infrequently. Some of our interviewees have invested in domestic PERE funds geared at specialty property types (i.e. student or seniors housing) or niche, value-add programs (i.e. retail), however their strongest commitment has been and continues to be towards internationally-focused funds.

International investing is riskier than domestic investing because of differences in market transparency, cultural norms and legislation. To this end, institutions are using global PERE funds to gain exposure to attractive, but less familiar, foreign markets with long-term growth prospects such as the U.S., Latin America, Europe and Asia. In investing through such vehicles, investors are able to achieve a number of objectives: (a) access local execution capabilities in target markets, (b) access deal flow in target markets, (c) form long-term relationships with sponsors, investors and local partners, (d) establish the potential for future co-investment with the fund and/or sponsor, and (e) achieve higher returns than may be available from similar types of investments domestically.

Our interviewees report undertaking substantial due diligence prior to committing capital to a particular PERE fund. One investor stated that they had investigated hundreds of funds in order to invest in about half a dozen. The selection criteria most cited by these investors, demonstrate the strategic motivation behind such investments, including:

- **Sponsor** – What is their track record? How strong is their local platform? What are the prospects for future business with them? What is their approach to governance?
- **Strategy** – How compelling is the opportunity? How well does it fit with the investor’s long-term strategy? What risk/return profile does it entail?
- **Size** – How material will the investor’s participation be to the sponsor?
- **Investors** – Who are the other investors? Are their opportunities to partner with them in the future?

Our interviewees expressed overall satisfaction with their PERE fund experience to date. They intend to continue to rely on PERE funds as a complement to their existing real estate strategies, and in many cases, their exposure to PERE funds is likely to increase as a function of their commitment to global investing. But this was not a unanimous view. As investors acquire experience in new markets, some are likely to shift to more direct investment approaches such as joint ventures.
Outlook

The credit crunch that began in the second half of 2007 has brought into focus the question of how dependent the PERE fund phenomenon has been on the availability and cost of capital. In general, turmoil in the credit markets will make financing acquisitions tougher and more costly. It is also likely to drive cap rate expansion, negatively impacting values. Private Equity Intelligence reports that PERE fund raising activity in the third quarter of 2007 dipped noticeably. Might this be indicative of a longer-term shift away from the PERE fund format? Also, what are the implications for the performance of existing funds currently in their investment or harvesting phase?

As we have identified in this paper, institutional commitments to PERE funds are driven by: (a) allocations to real estate; (b) real estate strategies aimed at growth and diversification; and (c) past performance of these funds. Leading institutional investors look favourably at funds that have identified legitimate opportunities for value-adding activity, and have the expertise to realize upon such opportunities. Leverage is not the driver, but is used to enhance the return from an already good investment idea. As long as PERE fund managers continue to envision credible opportunities, and real estate allocations remain strong, institutional support for such funds will persist.

While the current state of the capital markets continues, it is likely that the pace of acquisition activity will decrease, and that very large and complex transactions may not be as financeable. To the extent that such conditions contribute to distress amongst highly-leveraged owners and that price expectations of vendors are lowered, it is likely that PERE funds will see better buying opportunities in the medium term. From a mezzanine lending perspective, PERE funds should find increasing opportunities to lend at more conservative levels against better quality assets. A Fall 2007 report by Ernst & Young indicates that PERE funds are accumulating capital in anticipation of the above.

Some perspective on the performance of private equity funds following boom periods is provided by Kaplan and Schoar. Their study found that while aggregate industry returns tend to decline, this is primarily driven by the poor performance of new entrants. The returns of established funds are not as susceptible to industry cycles. The current state of economic and financial markets presents two scenarios. On the one hand, there will likely be some funds that will suffer, and if Kaplan and Schoar’s study holds true in the PERE fund sector, it will be amongst the newer sponsors. On the other hand, proven fund managers should continue to do reasonably well, and should be well-positioned to benefit from a new batch of distressed situations. It is important to note that PERE funds have been in existence since the early 1990s, and it was during that period of illiquidity in which many of today’s largest and most prominent PERE firms were conceived.
Summary

PERE funds are well-suited to pursue opportunistic investment strategies. Fund structures can be used to: (a) exploit niche opportunities; (b) gain access to new markets; and (c) enhance portfolio returns. PERE funds have enjoyed a strong performance record, assumed an increasingly influential role in the real estate investment market, and achieved widespread acceptance among institutional investors.

An important caveat is that the success of PERE funds over recent years, has taken place during a period of cap rate compression. Even poorly managed PERE funds would have shown strong absolute returns. As many industry professionals concede: “Over the past few years, we’ve all looked like geniuses.” \(^{34}\) The period of cap rate compression is over and superior returns will not be achieved except through creative and disciplined management.

While levels of exposure to them may vary, PERE funds are expected to remain a permanent fixture within the investment portfolios of institutional investors for the foreseeable future, primarily because of the impact that management can have on real estate performance. As one PERE fund manager has stated: “There has never been a better time in the history of investment real estate to create value by leveraging the creativity of human capital.” \(^{35}\)

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Notes

2 “Public Value: A Primer on Private Equity,” Private Equity Council, 2007, 8; according to Private Equity Council, “in contrast to private equity, hedge funds are a more broadly-defined category of investment pools that, like retail mutual funds, principally invest in publicly-traded securities, currencies or commodities.” While offering more liquid investments, hedge fund products provide little operating control, are more susceptible to capital market volatility, and are generally more speculative in nature, relying primarily on market timing and arbitrage.
3 “The Credit Crunch,” Real Estate Spotlight, Private Equity Intelligence Ltd., October 2007 1, No.5, 1.
5 Ibid., 1.
6 Linda McDonald and Brooke Stiver, “Institutional Real Estate - Investment Style Categories”, CRA RogersCasey LLC, December 15, 2004, 7-19; Private Equity Intelligence, phone interview, Fall 2007.
7 PERE fund managers, multiple in-person interviews, Summer-Fall 2007.
8 “Market Outlook: Trends in the Real Estate Private Equity Industry”, Ernst & Young, September 7, 2007, 2.; This survey of U.S.-based PERE sponsors suggests that approximately 80% of the investor base in PERE funds of $500 million or more are accounted for by these two categories of investors.
9 PERE fund managers, multiple in-person interviews, Summer-Fall 2007.
10 Ibid.
12 Ibid.
13 Ibid.
14 Institutional allocation to real estate, multiple in-person interviews, Summer-Fall 2007.
15 We have estimated total fund raising for the full year 2007 based on data from Private Equity Intelligence. Allocations by fund type and geographic focus is based on half year data.
16 The other common metric is the equity multiple ratio, which is calculated by dividing total cash distribution, plus residual net asset value of the fund’s remaining portfolio, by the total cash investment of the limited partners.
17 It may not be practical to establish a PERE fund industry benchmark because of wide variations in the strategies and risk profiles within the fund universe.
18 As of December 2007, Private Equity Intelligence’s database had 471 funds, of which only 197 reported IRR figures.
20 PERE fund managers, various in-person interviews, Summer-Fall 2007.
21 “Fundraising Update,” Real Estate Spotlight, Private Equity Intelligence Ltd., June 2007 1, No.1, 5.
22 For the purpose of this discussion, there is no difference between value-add and opportunistic investments.
24 Equity Office transaction, observation research, multiple in-person interviews, Fall 2007.
27 Ibid.
29 Bentall Capital, in-person interview, Fall 2007.
31 “The Credit Crunch,” 1.
35 PERE fund manager, in-person interview, Summer 2007.