The Business of Real Estate after the Great Recession

A new environment for commercial real estate.

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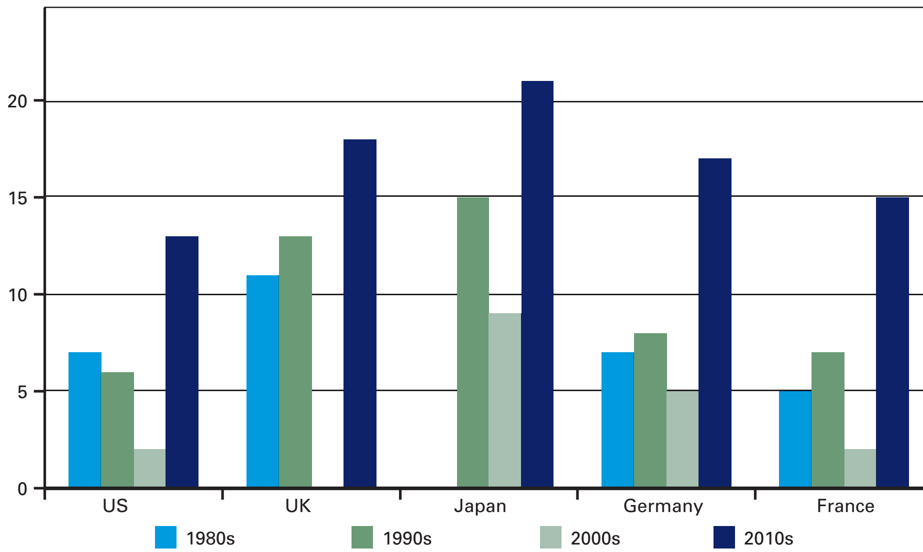
FOLLOWING THE WORST global recession in seventy years, risk aversion is prevalent and growth expectations are subdued. The global economy continues along a decade-long process of deleveraging, and austerity among industrialized nations is more likely than continued stimulus. With a backdrop of tepid global growth and elevated uncertainty, investors' return expectations have declined. Not surprisingly, investors have sought safety and yield, causing benchmark rates and risk spreads to tighten.

Compared to prior recoveries, it will take significantly longer for developed nations to return to prior peak GDP levels. Unemployment rates in developed

Figure 1: Slower recovery vs. prior recessions
Number of quarters to return to prior peak GDP



economies will remain substantially higher (average of 7.6 percent versus 6.3 percent during 2000 recovery and 7.1 percent during 1990s recovery). Government debt levels also remain extremely elevated (101 percent versus 70 percent of GDP). This is likely to result in a "slow growth" recovery in advanced economies (Figure 1).

Real estate's contractual nature provides a stable earnings basis between bonds and equities. Additionally, given its capital-intensive nature, commercial real estate typically thrives in a continued low interest rate environment, which we expect over the foreseeable near-term. Real estate in most countries around the world is priced at historically high spreads to government and corporate bonds, suggesting the sector is attractively valued. There is general consensus that real estate remains attractive relative to alternatives; however, markets remain bifurcated, and since demand growth is expected to be below trend and uneven, asset selection and product, sector and geographic strategies will be critical to making investment decisions.

CHANGING COMPETITIVE LANDSCAPE

Some of the biggest and strongest real estate investors through the peak of the last cycle were investment banks housing advisory and principal investment business lines under one roof. Morgan Stanley was one of the most aggressive investors, buying at least $53 billion of property and selling only $14 billion from 2005 to 2007, according to Real Capital Analytics, and currently has assets around $46 billion in its funds. Goldman Sachs's Whitehall Fund family invested $4 billion during this period.

Newly proposed laws put constraints on investment banks' ability to be advisors as well as principal investors. The proposed rule limiting principal capital to 3 percent of tier 1 capital means that banks such as Morgan Stanley and Goldman Sachs would have to liquidate up to 50 percent of their principal in their private equity vehicles. Additionally, investor dissatisfaction with the bank-sponsored blind pool model is well documented. The conflicts of interests with principal business activities, complex and excessive fee structures and intertwined real estate operations were not transparent enough for investors.

As a result of aggressive buying during the peak cycle, regulatory pressures and investor dissatisfaction, banks are likely to be the main players exiting the real estate investing market, with many already signaling this intent. Options include reducing their own capital in their funds, selling off vehicles altogether or disposing of assets via single or portfolio sales. Of the top sellers in 2010, Morgan Stanley heads the list with $5.3 billion of dispositions; Goldman has sold some $2.8 billion; and RBS $3.9 billion. Additionally, in March 2010, Citigroup Inc. sold its $3.5 billion real-estate investment business to Apollo. More recently, Bank of America sold its $2.7 billion Asian fund business to Blackstone.

Private-equity firms that historically have lacked a substantial property operation, including KKR, TPG, Centerbridge, Paulson and Rockpoint, have begun to acquire real-estate-focused business to further diversify away from their core expertise of leveraged buyouts to become broader-based asset managers. While these firms were hoping to buy distressed properties through FDIC or bank auctions, this has not prevailed due to bank extension programs and an overall lack of transactions. However, the new legislative reform, not over-leverage, may actually turn out to be the catalyst that may present them with buying opportunities. Hedge funds have been particularly active. Blackstone acquired $5.2 billion in 2010; Centerbridge and Paulson each acquired $3.9 billion. KKR recently named an ex-Goldman Sachs partner to head its real estate division, suggesting a more aggresive move into the commercial real estate market.

STRONG OPERATIONS

In a similar trend to moving away from bank-sponsored models, investors are likely to seek relationships with a general partner who has a strong operating track record, in-house property management and local knowledge and teams to filter good deals, manage assets and maximize returns in the cities they are marketing investment products. Firms such as Brookfield and BlackRock have operating platforms in real estate, and are significant operators, not just fund managers. They typically have higher co-invests (for example, Brookfield 20 percent to 25 percent) and leverage existing investor relationships from other parts of their asset management business (outside of real estate).

These firms may look to increase their exposure by acquiring large portfolios or complete funds management businesses to allow them to access new markets as well as more investors. Recently they have been active in the real estate space. BlackRock launched a fund as part of a public-private investment program and Brookfield has recently made a number of acquisitions, including assets from the JPM portfolio for $700 million. Other noticeable operators that have been active in buying include Simon ($2.9 billion), CBRE ($2.8 billion) and Inland ($1.8 billion) in 2010.

The traditional investment management fund model is evolving. Investors are demanding more involvement in deals seeking smaller fund sizes and quicker allocation of capital to investment. Investors now prefer to allocate a small amount of capital to a vehicle up front and then allocate more capital once a deal is identified and fees are now typically levied on invested, not committed, capital. Investors realized they had no control in closed-end funds and are now seeking more transparency, in some cases down to the deal level. This is increasing the prevalence of club deals and joint ventures. The recently proposed Volcker Rule of a 3 percent co-invest limitation will also challenge the traditional fund model.

There may also be a short-term shift to separate accounts as a means to build and maintain relationships, with an increasing number of mandates being handed out. However, once market stability and investor confidence returns, the model may shift back to club deals and small-sized funds to increase returns. We are already seeing this in the core space, with investor appetite increasing over the past 12 months (43 percent prefer core strategy versus 34 percent six months ago), perceiving the asset class to be less risky and offer attractive returns relative to alternative bond or equity instruments. It is likely that investors will also come back into value-add and opportunistic funds and club deals as the economic recovery takes shape.

INVESTING LOCALLY AND GLOBALLY

Increasingly, the volume of available capital has shifted away from the United

States. Considering the assets held by the top 200 pension funds and top fifty sovereign wealth funds in 2010, 27 percent is domiciled in the United States, compared with 34 percent in Asia, 25 percent in Europe and 7 percent in the Middle East and 7 percent in Canada and South America. Five of the top ten buyers in 2010 came from Asia, acquiring $30 billion in property deals, suggesting a current active appetite for commercial property.

In addition to focusing on global capital sources, the level of economic uncertainty has also reduced cross-border capital flows, with many domestic investors now focusing on their own local markets. Of the $250 billion of capital deployed to real estate since 2009, 80 percent has remained local. Markets such as the United States (84 percent), UK (90 percent), France (93 percent), Australia (96 percent), China (96 percent) and Japan (90 percent) all deploy 80 percent or more of capital originated to their own domestic market. Only Germany (74 percent), South Korea (55 percent), Canada (74 percent), Sweden (76 percent) and the Middle East (24 percent) have less than 80 percent of capital that originates in their markets deployed locally. This suggests successful firms will need to develop tailored, niche, regional products to support the needs of local investors as well as more global, core strategies that meet the needs of larger global players, looking to invest outside their local markets.

In summary, opportunities for outsized returns based on capital appreciation will be replaced by attractive, normalized returns based on income flows. In this environment, we will see a reshaped competitive landscape and the emergence of operators who can access global capital sources, who focus on aligning investor interests and who have proven property management experience in local markets to take advantage of value-add opportunities as economies recover.