CAIS IQ

Private Real Estate

Foundations of Alternative Investments

Co-authored by Mercer

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Private Real Estate, an Introduction

Private real estate is a popular asset class used by institutional investors such as pensions, endowments and family offices, as well as individual investors. Investors seeking to access alternative sources of income and growth, as well as to diversify traditional portfolio exposures, often will explore opportunities in real estate. It is generally defined as tangible property consisting of land, buildings, and other improvements. The real estate market is vast in size with many components for investors to consider prior to considering an investment. It potentially provides an opportunity to complement common investment exposures to traditional and other alternative asset classes.[1]

What is Private Real Estate?

Investments in real estate can be made in both the public listed markets or through private transactions. For **public markets**, access comes through either listed, publicly traded **Real Estate Investment Trusts ("REIT") on the equity side**, or on the **fixed income side with Commercial Mortgage-Backed Securities ("CMBS") or Residential Mortgage-Backed Securities ("RMBS"). Publicly listed real estate investments have historically demonstrated increased market volatility and may not provide the diversification desired by an investor relative to traditional investments.[2]** This overview will focus on the private market opportunities within real estate and all further references to the asset class are to the private market unless otherwise noted.

Private real estate encompasses investment opportunities that are not available on an exchange, or otherwise generally available to the public. Many properties, land and assets are owned by sophisticated investors, including commingled investment funds, large institutional investors, and high/ultra-high-net-worth investors, among others. Real estate is commonly described by investment profile, sector type, and market strength. Each category has unique risk and return profiles and liquidity constraints to consider when reviewing an opportunity or when building a diversified real estate portfolio.

Real estate is often considered a **diversifying complement** to a traditional asset portfolio given the general **risk and return dynamics** of the asset class that has historically exhibited **lower correlations with traditional asset class returns.** In general, the value of real estate can be represented by the discounted value of future cash flows that the property creates for its owner. Three common methods to determine real estate value include:

1. Fundamental analysis through historical and projected **net operating income ("NOI"**) and **capitalization rates (cap rates).**

2. **Appraisal values of similar properties** that have recently been transacted in the same or similar markets.

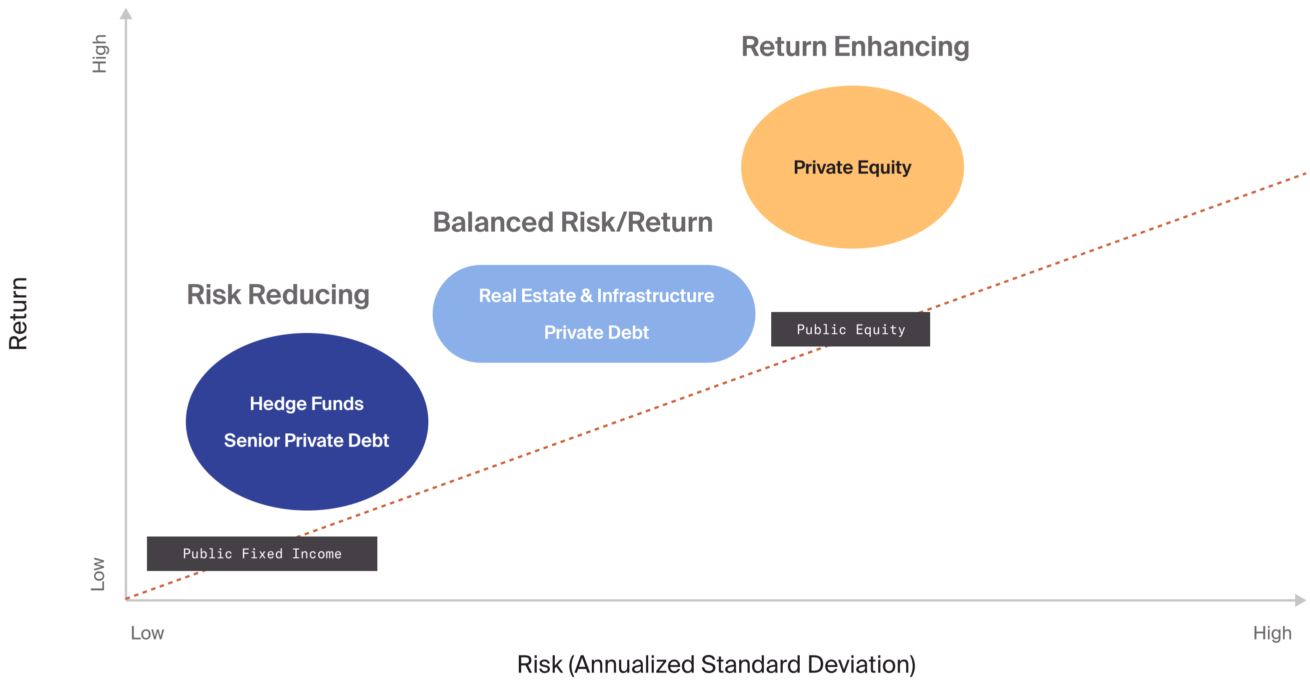
3. **Replacement cost,** or what the cost would be to rebuild the asset today from ground-up development.

Real estate owners are compensated by tenants typically in the form of a lease (rent) payment. Lease terms and occupancy levels vary from property to property and affect its value. Developers of new properties often seek to pre-lease a property, at least to an anchor tenant, to reduce speculation risk and the

[1] Mercer, Real Estate as an Asset Class, 2019.
[2] Mercer, Global Real Estate Overview, 2019.

FIGURE 1

Understanding Risk and Return for Alternative Investments



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uncertainty in attracting tenants after development. Developers prefer to create an asset that can generate future cash flows. Once developed, they typically attempt to sell the stabilized asset to capitalize on value created.

Understanding the Different Private Real Estate Categories[3]

Real estate can be separated into many different categories. Investors should consider where a select investment opportunity fits in terms of investment profile, sector type, and potential market attractiveness.

Investment Profile

- **Core:** Core assets typically consist of high quality assets with high levels of occupancy. Often, these properties are located in some of the strongest locations. Core assets often have lower levels of leverage on the property and are held for longer periods of time. These

[3] Mercer, Real Estate Primer, 2018.

assets rarely require meaningful development or improvements to the property. Much of the return is derived from current income in the form of rent. Consequently, core assets typically have a lower risk/return profile.

- **Core Plus:** Core plus real estate assets are typically still high quality assets in strong markets, but likely require minor upgrades to increase occupancy or grow cash flows. Core plus managers may utilize a slightly greater amount of leverage on assets, resulting in a return profile that is derived equally from current income and capital appreciation, which can enhance risk.

- **Value-Add:** These investments typically require repositioning or redevelopment, but have existing tenants and current rental income. The majority of return typically comes from capital appreciation along with a supplemental current income component. Holding periods are typically shorter in these assets and moderate leverage is often utilized. Value-add real estate has moderate risk and reward dynamics.

- **Opportunistic:** Typically, special situation investments or distressed properties that may include: halted construction, bankruptcy, ground-up development, or heavy redevelopment. The majority of the return is expected from capital appreciation. There may be some current income but not much is expected, especially in the early period of the investment. Shorter holding periods are common as investors typically look to stabilize the asset and sell it to a core real estate buyer as soon as possible. These investments utilize more leverage to cover repositioning and development costs and to increase returns, which results in a higher risk/reward profile.

FIGURE 2

Private Real Estate Investment Profiles

CORE	High quality assets located in some of the strongest locations. 60% Inc / 40% Appreciation **Leverage:** 0% - 35% **Hold:** 7+ years **Development:** Minimal **Diversification:** High **Liquidity:** Moderate
CORE PLUS	High quality assets with minor upgrade requirements. Leverage utilized as a tool to enhance returns. 50% Inc / 50% Appreciation **Leverage:** 30% - 50% **Hold:** 5+ years **Development:** Minimal **Diversification:** Moderate **Liquidity:** Moderate
VALUE-ADD	Assets requiring repositioning or redevelopment to maximize the use of the asset. 40% Inc / 60% Appreciation **Leverage:** 40% - 70% **Hold:** 3 to 5 years **Development:** Moderate **Diversification:** Minimal **Liquidity:** None
OPPORTUNISTIC	Distressed properties & loans, ground-up development, and entry level investing. 30% Inc / 70% Appreciation **Leverage:** 50% - 75% **Hold:** 3 to 5 years **Development:** Moderate/High **Diversification:** Minimal **Liquidity:** None

Source: Mercer. For illustrative and educational purposes only.

Sector Type

- **Industrial:** Properties used for warehouse, e-commerce distribution centers, logistics, production and manufacturing.
- **Retail:** Buildings where consumers buy goods or services. Brick and Mortar is commonly used to describe physical retail space.
- **Multi-family:** Residential assets used to house multiple families, as compared to single home residential properties. Most commonly, these are apartment or condominium buildings but may include hotels and other more niche categories.
- **Office:** Buildings used to conduct commercial and professional work. These assets typically have long leases from tenants.
- Other niche categories include the following:
  - **Storage**
  - **Medical Office**
  - **Senior Housing**
  - **Student Housing**
  - **Data Centers**

Potential Market Attractiveness

In real estate markets, select Metropolitan Statistical Areas ("MSAs") are categorized based on the potential attractiveness and resiliency of the local market.

- **Primary:** High population density markets that may include diversified local economies, barriers to entry (space constrained), and larger more liquid real estate markets. These markets are also commonly referred to as gateway cities.
- **Secondary:** The next tier of attractive markets, generally lagging behind primary in one or more of the above categories.
- **Tertiary:** Weaker secondary markets in a number of the above categories.

Core Foundations of Private Real Estate

The Structure & Phases

Private real estate investments can be made through **a direct transaction for a single property, direct acquisition of a portfolio of assets,** or through a **diversified commingled fund.**

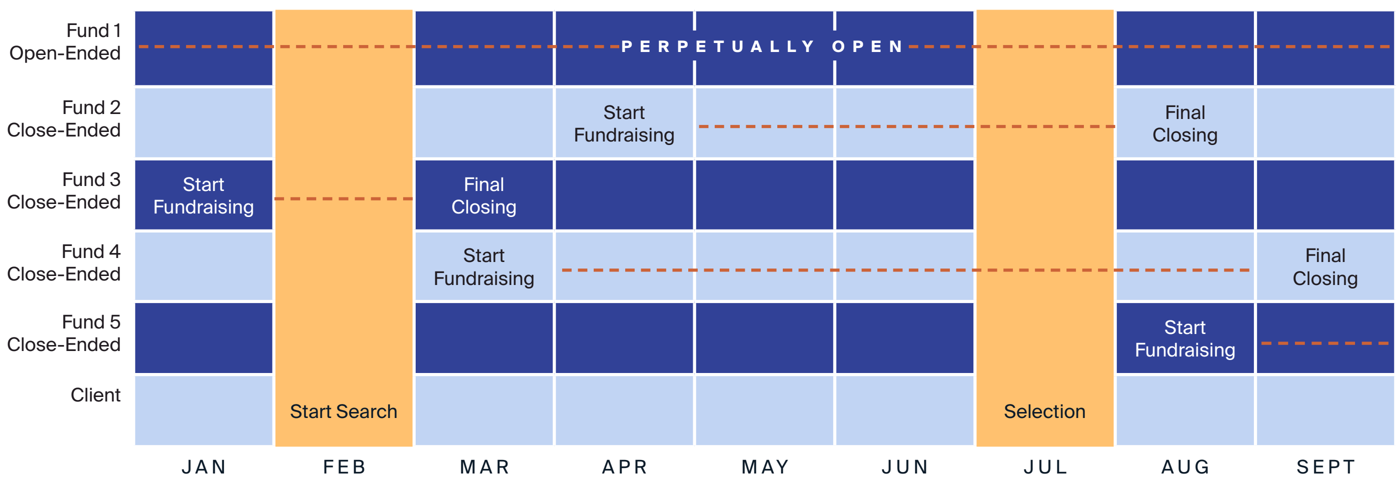
Commingled funds are typically structured as **limited partnerships or REITs** where the **investment managers** (typically the **General Partner or GP**, or an affiliate thereof) generally **oversee the investment of the fund's assets,** manage the day-to-day operations of the fund, and **serve the interests of Limited Partners ("LPs") that supply capital.** LPs typically seek to benefit from the skill and expertise of the GP in not only selecting good investments, but in providing incremental value creation to portfolio properties and to restructure and improve operating performance. For the life of the partnership, **the limited partner is generally considered a passive,**

FIGURE 3

The Periodic Nature of Fund Raising

Open-ended fund: Open-ended funds can be entered and exited at any time by an investor but sometimes subject to contribution and redemption queues. Open-ended funds are typically a core or core plus vehicle.

Close-ended fund: Close-ended funds have a fundraising period that lasts anywhere from 3 months to 18 months. Accordingly, investors have a finite time in which to invest in a close-ended fund. Close-ended funds are typically value add and opportunistic vehicles.



Source: Mercer. For illustrative and educational purposes only.

or silent partner, having neither responsibility beyond the capital it commits nor control over the timing of the investments or distributions.

Private real estate funds can be open-ended, most often in the case of core or core plus real estate, or close-ended drawdown structures. **Open-ended structures are commonly structured to allow quarterly subscriptions and quarterly redemptions.** It should be noted, however, that real estate is a relatively illiquid asset class and it may take several quarters to fully redeem, even in the open-ended vehicles that offer liquidity.

While many funds are formed as limited partnerships, others may be **REITs**, which have additional tax benefits along with more restrictions. REITs can invest in the equity of properties or they can hold a pool of mortgages, called a mortgage REIT. Some REITs, commonly referred to as hybrid REITs, will hold both equity and debt. **REITs benefit from lower tax rates per the Tax Cuts and Jobs Act of 2017. To qualify as a REIT, 75% of all gross income in the vehicle must be from rental income, interest on mortgages financing real property, or sales of real estate and 90% of all taxable income in the vehicle is required to be paid as a dividend to investors.**[4] Investors should consider dividend coverage ratios when evaluating REITs to ensure that the vehicle remains compliant with REIT requirements.

[4] National Association of Real Estate Investment Trusts.

Drawdown structures are characterized by an investor committing a certain amount of capital to the fund with a predetermined fixed term life although generally subject to term extensions. The initial phase is commonly referred to as the **commitment phase** and is marked by the GP's capital raising efforts and investors committing capital. The **investment phase** (or investment period) commences once the GP starts drawing on investor capital commitments to invest in real estate deals and implement their strategy.

During the investment phase, the GP accesses the limited partners' capital through what is known as a capital call. Capital is called as the GP identifies attractive investment opportunities in real estate assets. Capital can be called all at once or fractionally over time and is usually done over several years. The **harvest phase** generally begins once the required capital has been called and deployed into portfolio companies, though it can overlap with the investment phase when early investments are sold quickly or in the case of income producing assets.

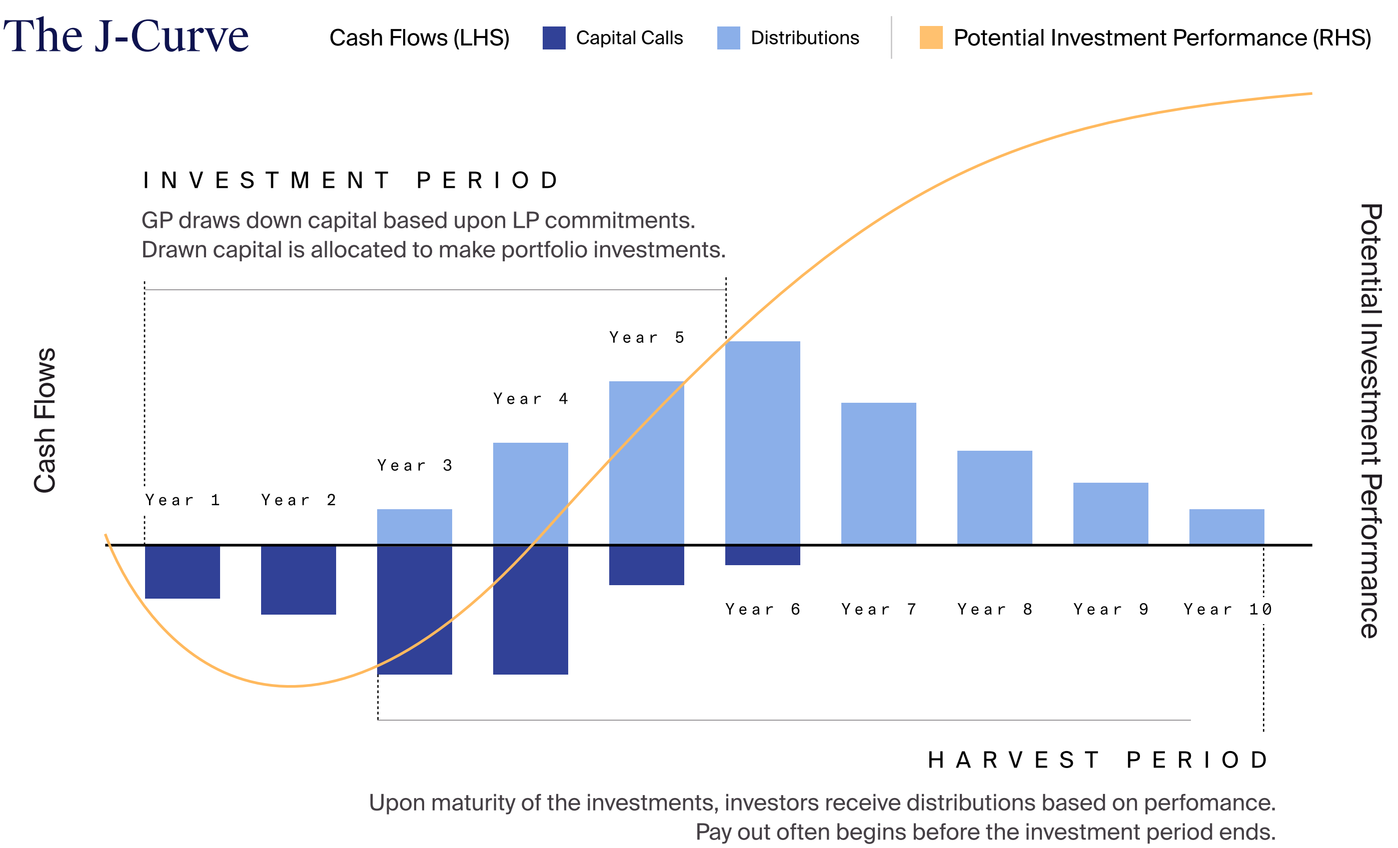
The GP's focus and aims are on improving the fund's investments and ultimately exiting at a substantial profit. While less common in real estate, during the harvest phase, the GP may have the ability to exit early investments and either reinvest the proceeds into new properties or distribute capital to investors ("LPs"). Unlike open-ended funds and other alternative investments, such as hedge funds, where investors can generally direct the sale of their investment and receive the proceeds, private real estate investors receive their capital only when the GP decides to make a distribution, much like private equity.

The J-Curve

The J-Curve is common to most private real estate investments. As Figure 4 shows, capital calls in the early years of the investment generally produce negative cash flows. In addition, negative returns are common as management fees are paid without seeing

FIGURE 4

The J-Curve



Source: Mercer. For illustrative and educational purposes only.

a return on investment. This may take several years to turn positive as underlying investments are marked up to their current value or gains realized through exit transactions. Distributions typically start several years after the investment phase begins and continue for multiple years thereafter. **Real estate investments that produce current income from tenants can soften or mitigate the size of the J-Curve.**

Three reasons for this "J" trajectory include:

- **Management fees and expenses generally occur during the investment period and are greater than early investment returns.** They impact the depth and duration of the J-Curve. Since management fees can be charged on the entire committed capital value, regardless of whether it has been called for or not, there is a negative cash flow associated with these charges. Additionally, certain expenses incurred by the GP to source and close deals are often borne by the fund.

- **GPs are typically quick to address non-performing investments, writing them off and redeploying the capital into other opportunities.** This can negatively impact performance in a fund's early years.

- **Conservative managers not only quickly write down underperforming investments, they often also hold investments at cost**, writing them up only after they have been realized through an exit transaction and value has been recognized.

The J-Curve effect is mostly unavoidable and generally accepted as part of the return experience by long-term investors in private real estate. To address it, investors must prudently manage other investments to make certain liquidity is available when the GPs call commitments and through patience with early reported returns that are not indicative of potential long-term success.

Potential Value Creation in Private Real Estate

Private real estate has unique characteristics and features that assist GPs in adding value.

- **Long-Term Investment Horizon:** Investments in private real estate are typically made for long periods of time. This is reflective not only of the time it takes to source properties, but also the time necessary for a GP to unlock value within each portfolio property as part of their investment strategy.

- **Active Management:** Private real estate in general is an active strategy. Managers may acquire core property and passively manage them, but this still requires property management teams for leasing, maintenance, and other needs. Managers may retain these services in-house as part of a vertical integration or outsource to third party specialists. Similarly, managers repositioning or developing assets must actively source properties and oversee the management and construction, lease them, and find buyers to exit.

- **Proprietary Deal Sourcing:** Sourcing real estate transactions can be very competitive in top markets. Many larger properties are transacted through brokers, which typically requires personal networks on the investment team. Many other deals are sourced off-market where there is no competitive auction for the property. Sourcing attractive deals at good valuations directly impacts value creation.

- **Operational and Structural Improvements:** Managers seek to create value within properties by either improving the operations of the property, such as lowering maintenance and property cost, or by improving occupancy rates. Developers seek to generate value through construction or structural improvements.

Realizing Value Through an Exit

An exit transaction is the primary driver to recognize value creation. Private real estate funds can exit their properties in many ways. The developer may elect to **recapitalize the property following development** and lease-up and to **sell the asset to a core market participant** seeking stabilized income producing properties. A core property owner may **sell to another buyer of core property.** Properties can be **sold one by one or as a full or partial portfolio,** as is often the case when the buyer is a publicly registered REIT.

Noteworthy Risks of Private Real Estate

- **Illiquidity:** Private real estate investments are generally illiquid given the structure of real estate transactions. The GP controls the investment decisions and an LP may only be able to exit their partnership interest in a secondary market that may have few, or no buyers, or at a discount to stated value. In the case of an open-ended fund, it can still take several quarters to redeem an investor's interest.

- **Volatility:** Private real estate is not a low risk investment and each category of real estate has unique risks. It is sometimes misunderstood to have low volatility, a standard measure of risk in financial assets. This misconception is due to the infrequent changes in the valuations of the underlying assets as well as the stages of deployment of capital to new properties.

- **Lack of Control:** LPs do not have control over the investment decisions or the timing of when the GP calls capital and makes investments for the private real estate fund. Given this, it is important to evaluate the skills and ability of the GP to execute on the stated investment strategy and to create value at the property level.

- **Leverage:** Real estate transactions typically involve mortgage financing from a bank or non-bank lender. Leverage and the sources of capital can vary materially and alter the risk and return profile. In the event of a bankruptcy, the bank or non-bank lender may have claim over the property before equity owners.

Allocating to Private Real Estate

Diversification

Diversifying private real estate investment exposures is prudent and an important part of a successful investment program. The key areas to diversify include[5]:

- **Manager:** Investors should allocate to multiple managers given the active management risk associated with private real estate. In private real estate this is critically important as each manager may have a unique specialty, skill, and view of markets. Exposure to multiple managers may also help to mitigate execution risk.

- **Liquidity:** At the property level, some real estate is more liquid than other types. At the fund level, certain funds have different liquidity (core vs. drawdown). The leverage used by a manger can impact the liquidity of a property and investors should seek to understand and potentially

[5] Mercer, Real Estate Primer, 2018.

diversify the use of leverage in their real estate portfolio. Assets with current income help to diversify the liquidity component as cash is returned to investors while the asset is held.

- **Strategy:** Including a variety of private real estate strategies (e.g. core, core plus, value-add, opportunistic) diversifies investor exposure, providing various return drivers and return profiles over the life of the investment.
- **Geographic:** As real estate is in physical locations, it is important to diversify exposure through multiple markets, regions, and even countries. This mitigates cyclicality of a portfolio through lower economic sensitivity to any one economy, whether local or national. Investors should also consider diversification to multiple market types (e.g. primary, secondary, tertiary) to diversify the return stream and risk dynamics.

FIGURE 5

Property Diversification

Source: Mercer. For illustrative and educational purposes only.

FIGURE 6

Building a Private Markets Portfolio: The Importance of Diversification

Source: Mercer. For illustrative and educational purposes only.

- **Property Sector:** Investors should consider diversifying their real estate portfolio across sectors (e.g. office, multi-family, industrial, retail) to mitigate economic risks.

- **Vintage Year:** To potentially be successful in private real estate, investors should consider vintage year diversification, putting money to work over multiple vintages. The asset class is long-term in nature and typically characterized by different stages that impact performance. Therefore, allocating investments over multiple years (e.g. vintages across 5-10 years) potentially mitigates risks due to market cycles and the timing of both entry and exit.

Manager Dispersion

Discretion in manager selection is important to ensure that the manager has the necessary relationships and execution skills required to potentially be a top-tier manager within the asset class.

Manager due diligence requires managers to demonstrate, clearly and persuasively:

- **Experience and Resources:** Market experience, global reach, and a well-resourced research team to source what are believed to be the best opportunities and create value.

- **Relationships and Tenure:** Building relationships with and gaining access to high-quality emerging and well-established fund managers takes time and commitment. The quality of those relationships can create access to future opportunities, particularly when the best managers have limited capacity. Access to a manager can never be guaranteed.

- **Operational Stability and Risk Management:** To address non-financial risk, governance and policies, systems, processes, and controls must be substantiated by an evaluation of middle and back office activities.

- **Reliable Track Record & AUM:** Managers should be able to provide proof of concept both to investors and counterparts.

Establishing an Allocation Strategy

Time and prudence should be considered when building a diversified private real estate portfolio. Investors seeking to implement a portfolio of core real estate can generally reach their allocation target in relatively short order given many investment opportunities are open-ended structures and fully invested at the time of subscription. However, investors seeking to use value-add or opportunistic real estate may need several years to reach a desired allocation due to the drawn down nature of the funds.

Three approaches to gain the desired private real estate exposure include:

- **Disciplined:** Create a capital deployment schedule that covers multiple years, vintages, and strategy types. While the timing of which managers and when those managers will be in the market raising capital is uncertain, upfront focus on building a diversified structure and relying on effective manager selection will better position investors for success.

- **Opportunistic:** The managers which best fit an investor's portfolio are chosen independent of weightings to each category or industry, and regardless of vintage year diversification. The resulting real estate portfolio may produce a less than optimal allocation, or lack diversification by vintage years.

- **Hybrid:** Some investors may look to utilize a disciplined approach to build a core allocation to private real estate, while at the same time, opportunistically commit to desired strategies as satellite exposures become available.

 |

Investor Profiles

Investors typically fall into one of three profiles across the risk/return spectrum. Asset allocation across the various real estate categories can vary and ranges even within individual profiles.

Profile 1: Investor has low tolerance for risk and targets mid to high single-digit returns. Current income is important. The investor allocates largely to core real estate assets with a smaller allocation to core plus assets.

Profile 2: Investor has moderate tolerance for risk and targets high single-digit to low double-digit returns. A blend of income and appreciation is important. The investor allocates to a mix of core, value-add, and opportunistic assets with less risky asset exposure.

Profile 3: Investor has moderate to high tolerance for risk. Real estate serves primarily as a return enhancer with illiquidity being a non-concern. The investor allocates to core, value-add, and opportunistic assets, with greater exposure to riskier assets. ■

FIGURE 7

Investor Profiles

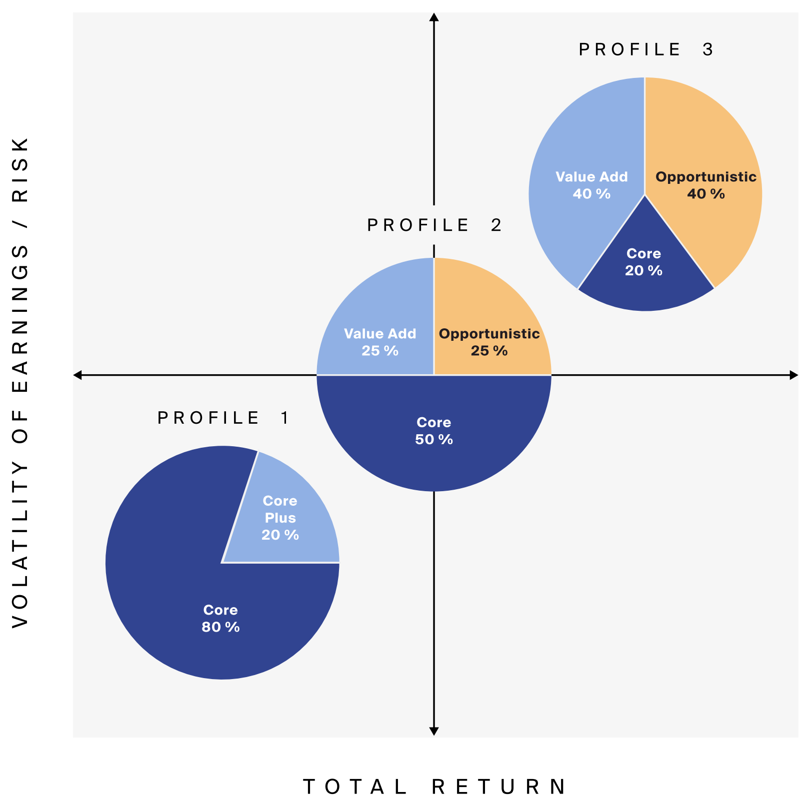


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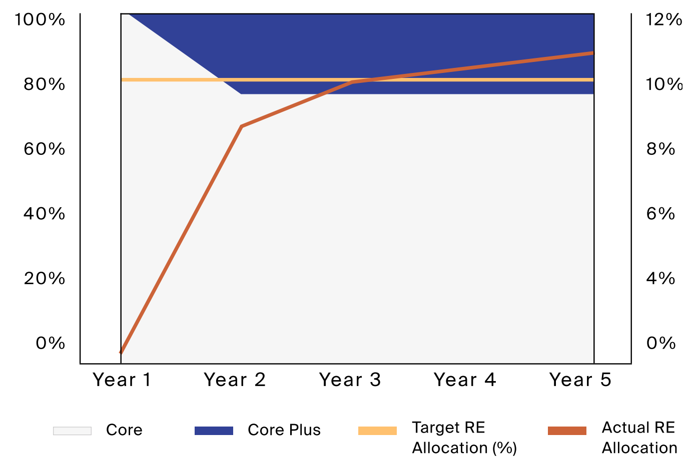
FIGURE 8

Portfolio Construction

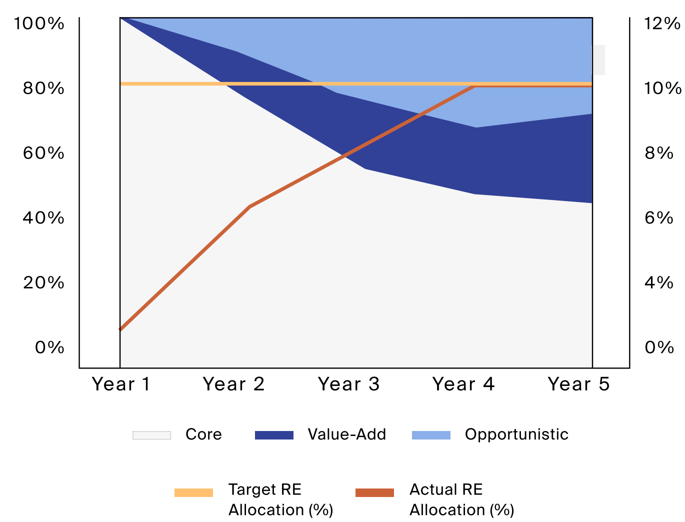
Investor Profile 1

- Steady real return over the long run
- Lower volatillity
- Portfolio ramped up relatively quickly as the open-ended funds call capital within first year



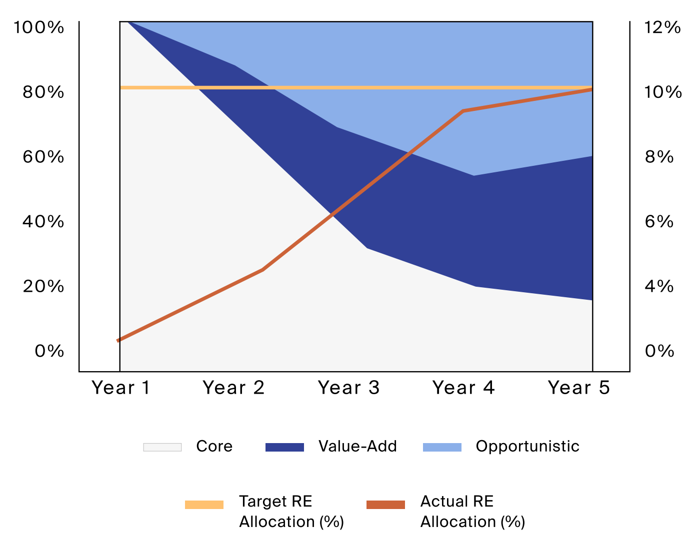
Investor Profile 2

- Steady real return over the long run
- Moderate volatillity
- Portfolio ramped up relatively quickly, and close-ended funds call capital slowly



Investor Profile 3

- High returns over the long run
- Higher volatillity
- Portfolio ramped up slowly over several years as close-ended funds call capital over a 2-4 year investment period



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Private Real Estate Terms

- **General Partners ("GPs"):** The professional investment managers that manage the fund's day-to-day operations. While management fees are typically paid to the Investment Manager, carried interests are allocated to the general partner.
- **Limited Partners ("LPs"):** The investors in the private fund, such as pensions, endowments, HNW and UHNW individuals, and foundations. LPs generally have no input into the investment and exit decisions. Their liability is generally limited to the amount of capital they commit or invest.
- **Capital Calls:** As the GP identifies opportunities and makes investment decisions, they will issue capital calls to LPs for all or a portion of their commitment.
- **Commitment:** The amount of capital that each LP contractually agrees to provide to the fund.
- **Investment Period:** The time period over which the GP can add new portfolio companies to the fund. This period varies from fund to fund. In certain circumstances, GPs can recycle an investor's capital during the investment period to enhance capital efficiency and improve returns.
- **Vintage:** Generally considered to be the year that the fund began investing capital. Vintage years are important to understand in terms of benchmarking and peer comparison given evolving market conditions over time.
- **Management Fee:** A fee to the Investment Manager to provide capital to pay salaries and expenses associated with running the fund.
- **Carried Interest:** A profit sharing between the LPs and GPs.
- **Preferred Return:** A minimum amount the GP agrees to pay the LP before participating in any carried interest.
- **Internal Rate of Return ("IRR"):** A money-weighted performance measurement and commonly used to measure the performance of private market investments because the GP controls the timing of the investments.
- **Multiple on Invested Capital ("MOIC"):** Another way to measure private real estate returns. A simplistic example would be for an investor that invests $100 into a fund and the fund later values that investor's interest at $150, or a 1.5x MOIC.
- **Net Operating Income ("NOI"):** The income you generate annually from an income property after property expenses have been taken into consideration.
- **Return on Investment ("ROI"):** Calculated benefit of an investment, divided by its cost.
- **Capitalization Rate:** Refers to the Net Operating Income (NOI) divided by an income property's current market value.
- **Loan to Value Ratio ("LVR"):** The percentage of an asset's sale price or value attributed to financing.

$$\text{Loan to Value Ratio} = \frac{\text{Mortgage Amount}}{\text{Appraised Asset Value}}$$

- **Real Estate Investment Trust ("REIT"):** A real estate investment trust refers to a corporation that owns or finances income property.

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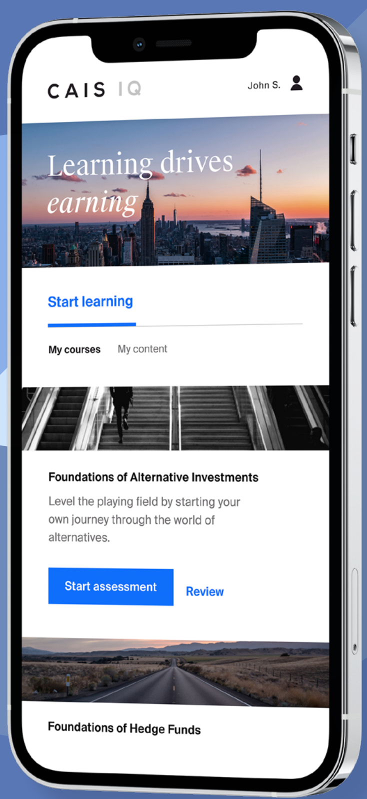

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