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NOVEMBER/DECEMBER 2007

Bear threatens, torrent continues – for now

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Looking for a way out..?

...we won't stand in your way. Real estate may be less illiquid than you think, even in today's liquidity-diminished times. **Ronald Dickerman** reports

Over the past few years, institutions have continued to modify their capital allocation models in order to take advantage of strong growth in the alternative investment sector. As a result, real estate markets have seen an unprecedented influx of both debt and equity capital from institutions through securitised lending, direct investment, and joint ventures. With larger portions of their overall investment portfolios comprised of real estate, institutional investors' focus on liquidity has noticeably evolved.

During the recent real estate bull market, broad access to both debt and equity capital allowed investors to monetise positions quickly through third-party sales, asset refinancings, and recapitalisations. With the onset of the sub-prime mortgage crisis and its spillover into the commercial credit markets, capital is not as readily available and investors are experiencing a decline in transaction velocity. The securitisation of the real estate debt capital markets through commercial mortgage-backed securities and other structured vehicles further diminishes liquidity due to restrictive prepayment penalties, defeasance costs, and prohibitive lockout periods. Combined, these factors inhibit investors' ability to exit early or monetise their equity positions, underscoring the need for practical liquidity solutions.

According to the report 'Emerging Trends in Real Estate 2007' produced by PricewaterhouseCoopers, the value of investment quality US and western European real estate is estimated to be in excess of \$6.6trn (€4.6trn). A significant portion of this real estate is held by illiquid real estate investment vehicles such as limited partnerships, limited liability companies, preferred equity investments, syndicated funds, development joint ventures and other joint ownership structures. The investors in these structures include pension funds, high net worth individuals, trusts,

life insurance companies, banks, syndicated fund sponsors and other foreign and domestic institutions. There is no formalised secondary market for investors seeking liquidity for their ownership interests in these joint ownership entities. Thus, when they seek an early exit, they have limited options.

In addition, pension funds and other investors in joint ownership structures struggle with a lack of transparency in these investments. For example, if an investor owns a property or portfolio outright, he or she receives all financial statements, rent rolls, etc, related to that property or portfolio. However, in situations where investors own smaller interests, which is often the case with pension funds, real estate investment vehicles are not legally required to provide extensive documentation and reports, and therefore typically decide not to put in the time and effort to create and distribute them to all investors. Again, since there is no formalised secondary market for indirect ownership interests, an overwhelming number of these investors are unclear on how the value of their interests is calculated and what their interests are worth in the marketplace.

There have always been few options for investors seeking liquidity for indirect ownership interests when they seek early exits from otherwise illiquid structures. Over the past several years, a handful of real estate private equity firms specialising in purchasing these 'secondary' interests have emerged, presenting investors with alternatives for liquidating their interests before the maturation of their investments. Current market conditions have intensified this need as cap rate compression has run its course and markets are perceived as fully valued. Investors, now more than ever, are seeking early exits.

In several markets, particularly in US and European tier 1 cities, real estate is being perceived as fully valued as a result of aggressive acquisitions and unprecedented cap rate compression. Although there is no

shortage of buyers for commercial real estate assets in top markets, there is a growing trend of investors seeking liquidity in order to redeploy investment capital into undervalued and emerging markets, such as Brazil, Russia, and India in the hopes of generating higher returns.

There is also a growing trend for joint venture partners seeking liquidity in fully valued markets for reasons ranging from a desire to redeploy capital into growth markets to realising gains while freeing up capital. Often these joint venture partners do not have a controlling interest, and so cannot influence the disposition timing of a property or portfolio. Their need for liquidity often does not correspond with the ultimate holding period of the other partner(s). Finding capital to satisfy the liquidity need in a joint venture scenario is now possible by going to real estate private equity firms that specialise in joint venture equity for existing ownership structures.

Also, lenders have grown more conservative in the wake of the sub-prime mortgage crisis. Obtaining 90% loan-to-value debt is much less prevalent than it was in the recent past. As a result, investors are forced to come up with larger blocks of equity in order to finance new real estate developments and acquisitions. Furthermore, as high leverage loans mature, substitution of equity becomes increasingly necessary to refinance existing deals, compelling investors to take on equity partners or mezzanine loans to bridge the gap in equity that they need upon refinancing a property or portfolio.

A confluence of factors has produced a real estate market of inhibited liquidity. As liquidity becomes a growing necessity for pension funds and other institutional investors in real estate, transparency is going to increasingly become a hot topic in the industry, and liquidity specialist firms will be a more visible source for providing solutions to liquidity issues.

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