Private Real Estate Co-Investing Today: Opportunities and Challenges

PERSPECTIVE FROM FRANKLIN REAL ASSET ADVISORS®

KEY POINTS

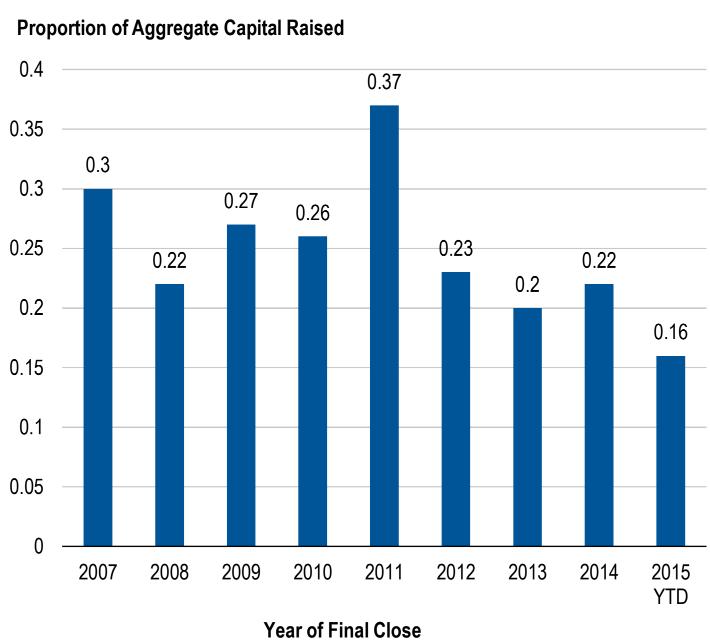
- Real estate co-investments and joint ventures are increasingly available as real estate fund managers find it harder to compete for capital with the "mega funds"
- Relative to investing in real estate funds, these single-asset or small portfolio transactions offer the possibility of:
  - attractive returns
  - favorable terms
  - the ability for investors to control portfolio construction
- Due to the challenges of accessing these transactions in a private market and performing the extensive due diligence required to underwrite them, those investors who are well-resourced with a strong network of contacts and a local presence in global real estate markets are best able take advantage of the opportunity

Investors in private equity funds are familiar with the opportunity to co-invest alongside the primary funds in which they participate as limited partners (LP). In a co-investment transaction, an LP has the opportunity to commit additional capital to an individual transaction, usually on attractive terms and in a vehicle which is separate to the fund that is also investing in the deal. Co-investing is now becoming more common in the private real estate market.

Prior to the global financial crisis in 2007–2008, co-investment opportunities in individual buildings or small portfolios of properties were scarce. Strong capital flows and the ease of obtaining finance meant private real estate fund managers tended to have enough available capital to finalize any potential deal within their real estate fund. That has changed significantly since 2008. Already a long and sometimes arduous process, raising capital for real estate funds has become more difficult. The financial crisis has made institutional investors more selective and they are increasingly looking for durable long-term track records. Moreover, investors are often opting to invest more money with fewer, larger managers.

These trends have led to a winner-take-all environment in the private real estate market as the competition for funds has intensified. As a result, the large "mega funds" have tended to raise the bulk of the capital, while smaller managers have often found themselves capital-starved. For example, the proportion of total capital raised for private real estate funds sponsored by "emerging" managers (those raising their, usually smaller, first or second fund) has dropped by 15 percentage points since it peaked in 2011 at 37%. And as Exhibit 1 illustrates, it has not risen above 23% at any point during the past four years.

Exhibit 1: Capital Raised by Emerging Managers as a Proportion of All Closed-End Private Real Estate Fundraising
As of October 20, 2015



Source: Preqin.

Co-investment opportunities are on the rise as players other than the "mega funds," unable in some cases to raise enough capital in their funds to fully invest in certain transactions, seek additional capital in order to complete desired transactions.

Another way of accessing real estate assets outside of the typical fund structure is a joint venture (JV). Joint ventures in private real estate tend to arise when a manager finds an opportunity but is currently not managing a primary fund with capital available to invest. In these cases, the manager may offer the opportunity to select investors on a stand-alone basis. If the resulting transaction is shared with just one capital provider, the two parties will form a joint venture to complete the deal. In some cases, these ventures become ongoing in a so-called programmatic real estate joint venture where the manager will provide a pipeline of future potential transactions to the JV.

Benefits of Including Co-Investments/Joint Ventures Alongside Primary Fund Investments

Co-investments and JVs involve either a single asset or a small portfolio of assets which investors can perform due diligence on before deciding to commit capital. For institutional investors with a specific set of portfolio construction goals, co-investments offer a way to allocate capital within the real estate portfolio *deliberately*, with *control* and with a greater degree of *certainty of outcome*. This contrasts with investing in a "blind pool" private real estate fund, where the ultimate portfolio exposure is unknown at the outset. Co-investments and JVs also offer the opportunity for investors to rapidly gain exposure to a desirable property market or sector, therefore increasing the ability to allocate capital tactically in dynamic market conditions.

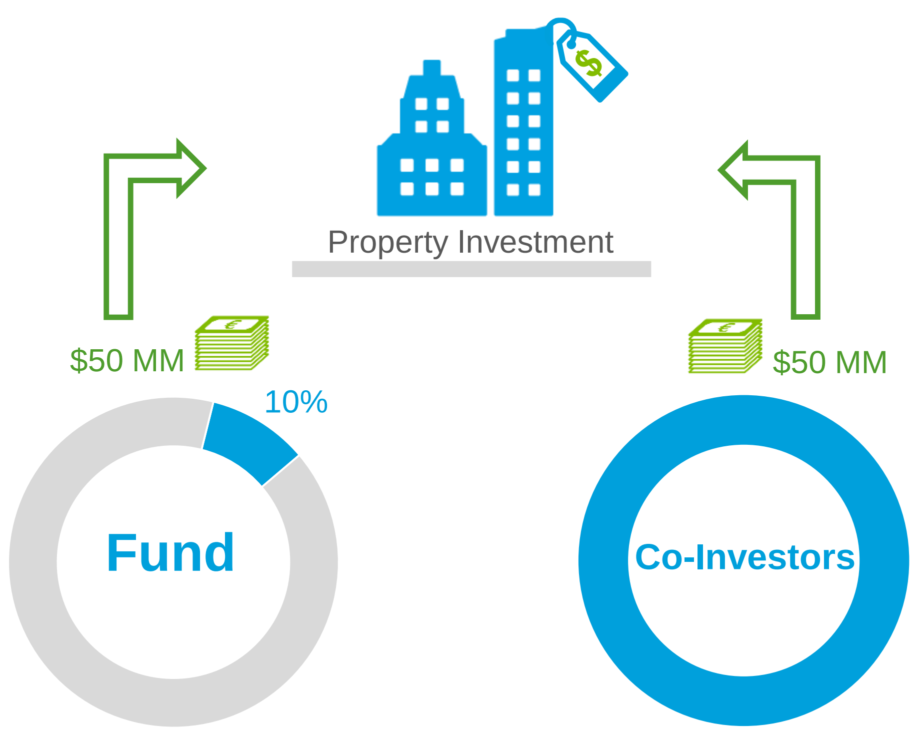
WHAT ARE REAL ESTATE CO-INVESTMENTS AND JOINT VENTURES?

At its most basic, co-investment arises when a private real estate fund manager secures the rights to a property transaction but lacks sufficient capital in the fund to fully cover the deal. To secure additional capital, a fund manager may offer existing LPs the opportunity to make an additional investment in the transaction as "co-investors" alongside the fund.

If the fund is still short the necessary capital, the manager may next approach outside parties for the remainder (see Exhibit 2). Here is where an investor with a robust global network and strong relationships can gain access to single asset or small portfolio transactions without, in some cases, having to commit any capital to the manager's fund.

Once the manager has secured enough additional co-investment capital, the transaction is shared between the primary fund and the co-investors on a pro-rata basis. Thus, co-investors who are also invested in the fund will have a more concentrated position in that particular asset or portfolio.

Exhibit 2: Real Estate Co-Investments/Joint Ventures: What Are They?



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In order to close the transaction, the capital committed to co-investments is typically called from investors immediately and fees are charged only on the capital which is invested. As such, the average cost of each dollar invested is lower than it would be in the primary fund because management fees are not being paid in a "commitment period" before the capital is actually deployed.

Real estate managers seeking co-investment/joint venture capital are motivated to provide favorable terms relative to those in the primary fund in order to attract the additional investment. These terms might include lower management fees (with no "commitment fee") and/or lower performance fees as well as improved investor control rights and governance provisions.

While co-investments may introduce concentration risk, within a broad, well-diversified real estate portfolio this can be beneficial provided it is properly underwritten at the individual asset level. In our own experience managing private real estate portfolios since 1997, including co-investments generates superior absolute returns for a portfolio of real estate funds. Co-investments' attractive return potential has long been demonstrated in the private equity industry at large. As Exhibit 3 illustrates, a recent Preqin survey of limited partners found that nearly two-thirds of co-investments significantly outperformed broader private equity fund returns.

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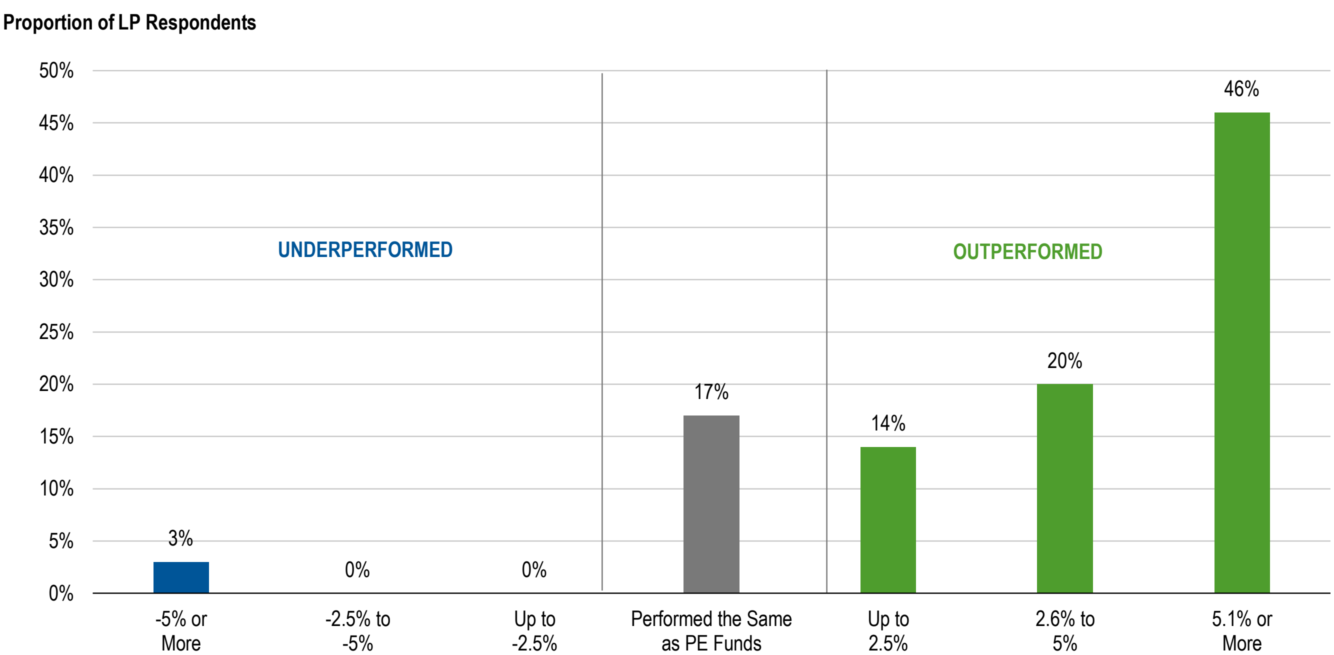
Obstacles to Making Co-Investment

Investors that are either new to private real estate investing or whose relationships are limited can find it difficult to identify and access attractive co-investment opportunities.

Since co-investment and joint-venture opportunities are often available for a short period of time and need to be closed swiftly, institutional investors without available "ad-hoc" resources may face practical challenges executing on an individual deal or series of transactions.

Exhibit 3: Performance of Past Co-Investments Compared to Private Equity (PE) Fund Returns
As of September 2015



Source: Preqin Investor Survey.

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Selecting the right individual co-investment or joint venture opportunity requires extensive, asset-level due diligence. To analyze the potential transaction effectively, an investor needs expertise in direct real estate investment and the associated analytical resources. The ability to analyze a transaction not only thoroughly, but also quickly is crucial.

INCLUDING CO-INVESTMENTS/JOINT VENTURES ALONGSIDE PRIMARY FUND INVESTMENTS

Benefits

- Portfolio construction
- Efficient capital deployment
- Favorable terms
- Improved risk/return outcomes

Obstacles

- Access
- Speed of execution
- Due diligence
- Risk management and portfolio construction

As noted above, adding a co-investment or joint venture to a real estate portfolio introduces asset concentration risk, and while this may be helpful in enhancing portfolio returns over the long run, it can result in an increased variability of returns given the outsized exposure to an individual asset or portfolio of assets. Getting the balance between co-investments and diversified fund investments exactly right is difficult, and a disciplined, time-tested investment, risk management and portfolio construction process is crucial to help minimize any adverse impact from concentration risk on the broader portfolio. In our view, a co-investment program is best pursued as a complement to an existing, broadly diversified real estate portfolio.

Conclusion

Real estate co-investments and joint ventures are becoming ever more attractive to institutional investors who wish to deploy capital deliberately and efficiently within a broad, diversified real estate portfolio. For those investors that have the in-house capabilities to conduct intensive asset-level due diligence to meet demanding investment deadlines, the benefits of co-investments and joint ventures are clear. However, for investors that lack the capabilities to access and underwrite these transactions quickly and effectively, partnering with an experienced investment advisor with global reach and access to local expertise can help investors extract the maximum value from co-investments and joint ventures while avoiding potentially costly mistakes.

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