PrivcapRE/
Context for Private Real Estate Investment
JANUARY 2014

2014 Real Estate Game Changers

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The Coming GP Shakeout / 10

Keynote Interview:

David Sherman of Metropolitan Real Estate

and expert insights from:

KKR· Jones Lang LaSalle · Hodes Weill · Colony Capital

Videos in this report

On Camera

Ralph Rosenberg: KKR's real estate chief on the trends to watch in 2014

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The Game Changers
A video round-up of expert predictions for 2014 including KKR, New York Common, Grosvenor, GreenOak, Chandan Economics, Fulcrum Hospitality, Oak Street and Probitas.

CRE Outlook for 2014
Metropolitan Real Estate President David Sherman discusses the risks and opportunities for 2014.

Japanese Capital Will 'Change The World' Once More
Japanese investors are looking overseas once more, and are set to target real estate. Charlie Haase of Tokyu Livable says that the capital will "change the world."

Wave of Foreign Capital Eyes Secondary Markets
Foreign investors are scooping up deals in secondary cities as they search for higher yields. Bruce Miller of Jones Lang LaSalle explains.

M&A Looms As Managers Seek Scale
David Hodes of Hodes Weill & Associates says this year will mark the return of the mega fund.

COMING SOON on PrivcapRE

GreenOak's "Core Four" Strategy: Navigating the Gateway Markets
Sonny Kalsi describes GreenOak's strategy for pinpointing value in saturated, major cities. Plus: why cap rates from secondary cities just don't cut it.

Growth And Dislocation in Latin America
For Philip Fitzgerald, CEO of Jamestown Latin America, the region is not one strategy; its diverse markets offer real estate investors the potential of growth—and dislocation.

Crowdfunding for Real Estate
Daniel Miller talks about Fundrise, a new crowdfunding platform that works to eliminate middlemen and outdated regulations in the commercial real estate market.

Adding to the Investment Model Menu
Mark Grinis, global leader of real estate investment fund services at EY, looks at how GPs are changing their offering to meet LP demands.

UPCOMING REPORTS

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March: **Multi-Family Housing Strategies & Student Housing**

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May: **Performance & Benchmaking**

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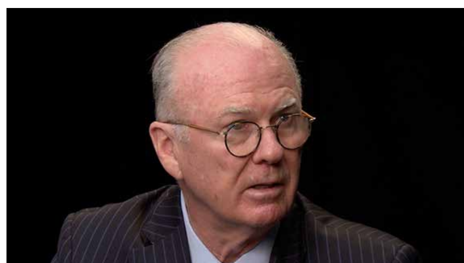

Choosing the Right Partner

Crosswater Realty Advisors president Ted Leary on how to choose the right manager and achieve alignment.

Capital Growth with KKR's Ralph Rosenberg

KKR's global head of real estate Ralph Rosenberg explains the firm's strategy for growth capital in the U.S., and how it's even lining up growth financing deals with development companies in Europe.

Retrenchment & Opportunity in European Real Estate

Jeffrey Lefleur of W. P. Carey talks about deal flow in a recovering European real estate market—where even adventurous buyers are staying closer to home.

Tom Barrack Urges Caution in Hospitality

Colony Capital CEO Tom Barrack, a man whose real estate repuation has been built on iconic hospitality deals, argues for an asset-light approach.

Deal Story: Aston Gardens Portfolio

Albert Rabil of Kayne Anderson Real Estate Advisors talks bout the Aston Gardens portfolio acquisition, one of the largest senior living transactions in the US in 2013.

Europe's Periphery Comes Into Play

Investors are turning away from Europe's ultra-core markets to its peripheral countries—with some core investors even eyeing the distressed GIIPS.

About PrivcapRE Special Reports

PrivcapRE Special Reports are exclusively for subscribers to PrivcapRE, the definitive channel for thought leadership in private real estate investment. Each month, PrivcapRE focuses on a critical investment theme and produces a package of thought-leadership content in multiple formats–a digital report, video interviews and panel discussions, and audio programs. The market intelligence of leading authorities forms the core of each package. PrivcapRE Special Reports help market participants better understand opportunities and practices in private real estate, and gain deep insights into potential investment partners.

PRIVCAPRE/ SPECIAL REPORTS

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Battle of the Game Changers:
Interest Rates vs. Cross-Border Capital

Rising interest rates will have a significant impact on commercial real estate in 2014, but it is the **unprecedented volume of cross-border capital** that will most fundamentally change the industry

Market analysis by Editor
Zoe Hughes

The commercial-property sector is set to undergo some significant changes in 2014. PrivcapRE's first Special Report for the year explores the trends that will impact the performance and composition of global real estate portfolios and investments.

Investors, managers, and industry professionals interviewed in the past six months offered a mixed forecast on the year's key trends. These include GP consolidation, the impact of new technology, risk and opportunity in Europe, the rise of the secondary market, and regulation. Some also expressed concern that the industry is repeating the "same old" mistakes, setting the stage for another crisis.

However, two key trends emerged as the most likely game changers: rising interest rates and the wave of offshore money looking for a home in commercial property.

> CROSS-BORDER CAPITAL FLOWS WILL HAVE A MORE FUNDAMENTAL IMPACT ON THE COMMERCIAL REAL ESTATE INDUSTRY IN 2014 THAN INTEREST RATES.
>
> -ZOE HUGHES

As developed markets across the globe weigh the issue of rising interest rates and potential cap rate expansion, there is serious concern that rental growth won't be able to keep pace. With faltering NOI growth, the industry is faced with the question of how to sustain some of the deals seen across the world's core gateway markets.

For example, in acquiring Manhattan's 650 Madison Avenue, the joint venture group led by Crown Acquisitions and Highgate Holdings paid a tight in-place cap rate of just 2.8 percent, according to Real Capital Analytics (RCA). The first year pro forma cap rate is expected to be 3.2 percent. If rates rise ahead of expectations and above NOI growth, is there enough cushion in the yield to make such a deal viable in the long-term?

The fear of rising rates has prompted some—including Colony Capital CEO Tom Barrack, interviewed on PrivcapRE in November—to brand investment in core markets "foolish." But it's not just core equity that's affected. Rising rates will have an impact on all deal underwriting, irrespective of where it lands on the risk spectrum, and could spell trouble for owners holding floating-rate debt.

Despite the obvious and significant impact of rising interest rates, market players expect cross-bor-

der capital flows to have an even more fundamental impact on the industry in 2014.

In the U.S., the six major metros saw a 900 percent increase in real estate investment by Chinese companies, according to RCA. A 40 percent stake in the most valuable office building in the U.S., the GM Building in Manhattan, was sold in June for $700 million to Zhang Xin's family (which runs Chinese office landlord Soho China) and a company controlled by Brazilian banker Moise Safra. The deal valued the GM Building at a staggering $3.4 billion, including debt. Activity in London, which remains a favorite for offshore buyers, showed similar energy.

The flood of foreign investment in the past 12 months is just a taste of what's to come. As Marjorie Tsang, director of strategic research and solutions at the New York State Common Retirement Fund, suggests, the "mother of all tsunamis of capital" is on the way in 2014. The Chinese are just one among many acquisitive groups, with vehicles out of Canada, Korea, Japan, Norway, Australia, and the Middle East also vying for offshore assets.

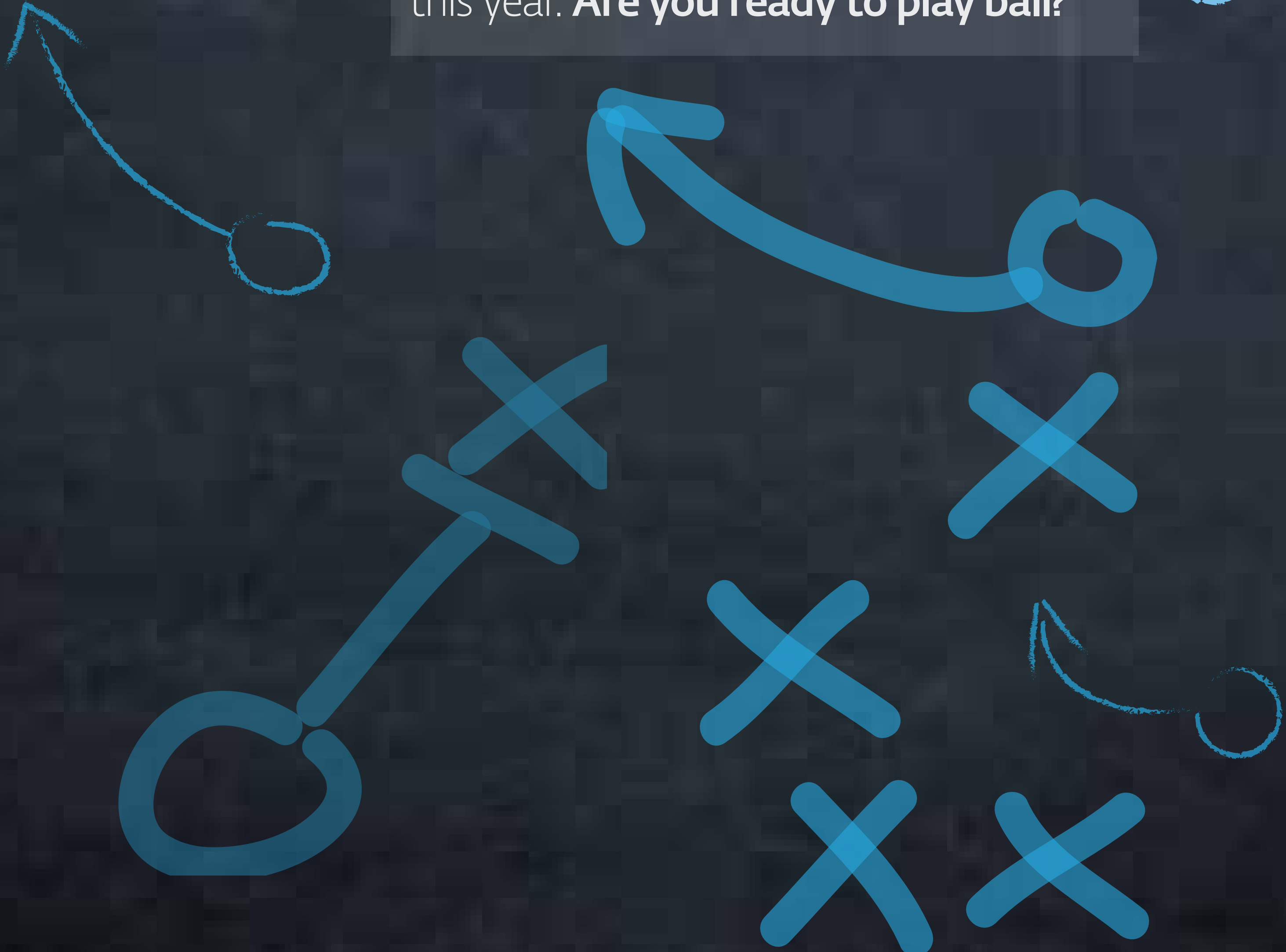
For domestic investors and private real estate managers, this presents a challenge and an opportunity. For investors, the competition for deals will only increase. Case in point: when the Chicago office property 225 West Wacker Drive sold to Seoul-based Mirae Asset Global Investments in March 2013, the Korean investor had to fight off bids from six other foreign investors and eight domestic investors. Pricing is already a concern for many in the market, and greater capital flows, particularly into prime global markets, are set to add to the upward pressure.

For managers, the new capital presents an opportunity. As domestic investors become more selective and consolidate their relationships with fewer managers, new sources of capital entering the market is a welcome trend. The managers that truly succeed in capturing this new foreign equity will be those able to customize co-investment rights, joint ventures, separate accounts, and club funds, all while ensuring that existing investor base—and their investment strategy—remain intact.

That will be tough to achieve, but managers need to embrace the opportunity and quickly learn how to play by the new rules of this ever-changing game./

2014 Real Estate *Game Changers*

An **expert overview** of the big trends driving commercial real estate investing this year. **Are you ready to play ball?**



The Game Changers

The three key trends to watch in 2014

1. RISING INTEREST RATES

Rates certainly can't get any lower in most developed markets, and all sensible real estate pros are preparing for rising interest rates in 2014. While the when and how are impossible to predict, the impact is not: rising rates will put pressure on cap rates and valuations. Just how much comes down to real estate fundamentals and the ability to raise net operating income to offset the higher financing costs. Those are very open questions as we head into the new year.

Whatever the outcome, smart investors view rising rates as a challenge *and* an opportunity. More than $350 billion of commercial real estate debt will mature in 2014, including $67 billion of CMBS, which is expected to experience the greatest challenge in refinancing. In January 2013, Barclays Capital estimated that only 50 percent of the CMBS loans originated in 2006 and 30 percent of those underwritten in 2007 had debt yields above 9 percent. With rising rates, the opportunities for CMBS workouts increases significantly.

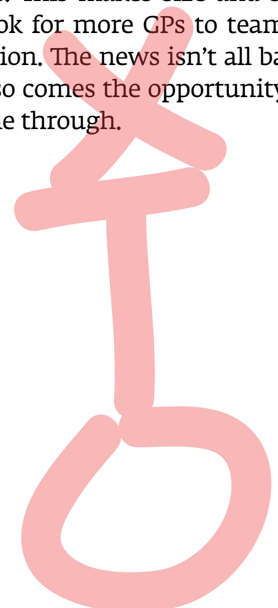
2. BOOMING FOREIGN CAPITAL FLOWS

Foreign investment played an unprecedented role in global real estate markets in 2013, and as investors continue to seek income and yield, 2014 is likely to be an even bigger year for cross-border capital flows. The biggest players? Asian investors, particularly the Chinese, who are being encouraged by Beijing to diversify and spend its mountain of foreign capital reserves.

It's not just the U.S. and its gateway cities, often the primary targets of foreign investors, that are benefiting. London topped the ranking of cross-border real estate investment in the 12 months to December 2013, according to Real Capital Analytics, attracting $22 billion of investment in more than 160 properties. Manhattan was in second place with $7 billion of deals; Paris, Sydney, and Shanghai followed close behind.

3. A WAVE OF GP CONSOLIDATION

One of the biggest challenges facing managers this year will be the ongoing trend among LPs to trim their GP relationships. This makes size and scale more attractive, so look for more GPs to team up via merger or acquisition. The news isn't all bad—with consolidation also comes the opportunity for new managers to shine through.



Game Changer 1

Interest Rates

Rising interest rates will squeeze real estate-project economics. Are you ready?

By **Christopher O'Dea**

The post-crisis liquidity surge from the U.S. Federal Reserve and other central banks has driven real estate prices higher, and the wide spread between cap rates and Treasuries may provide a cushion as interest rates begin their seemingly inevitable rise. So the question of just how much–and when–rates will increase and spreads will narrow is the central question for institutional real estate investors as we enter 2014.

What we're experiencing is 'The Amazing Race'," says Christopher Macke, senior strategist at CBRE Research. "It's a question of whether net operating income can keep pace with interest rates when they start rising." And while it's too early to predict how things will look at the finish line, Macke says, "the Fed has given asset values a head start."

There was no shortage of capital for the commercial real estate market in 2013, and market participants PrivcapRE spoke to projected continuing inflows in 2014, with activity concentrated in gateway markets and higher-quality properties. But with the interest rate on the benchmark 10-year U.S. Treasury already ticking higher amid signs of economic revival, it's only a matter of time before real estate-project economics are stress-tested. And it may not be a long wait; some analysts expect higher interest rates to exert significant pressure on cap rates as early as 2016.

Real estate investors will need to integrate a bond market outlook with traditional property and geographic market considerations in order to understand how the economic growth driving interest rates higher will affect the ability to preserve asset values by raising rents. Indeed, the bond market has rarely had such a large influence on real estate activity and valuation. The linkage is one result of the end of a three-decade decline in interest rates, a secular trend that came to a grinding halt early in 2013, making financing costs a more critical factor in every deal.

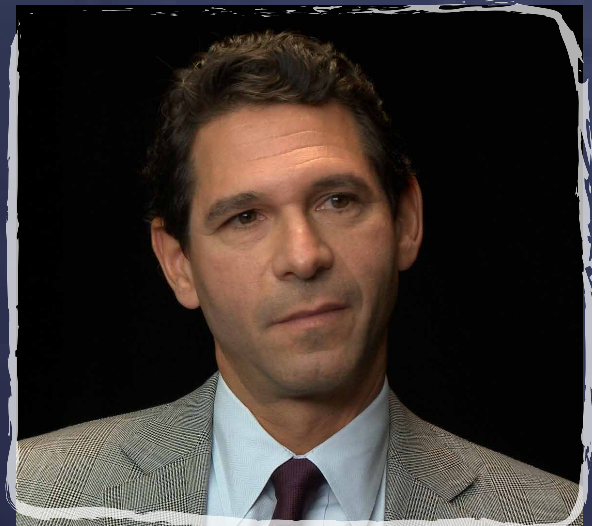
In May, says Macke, as the Fed first hinted it was preparing to slow its purchase of bonds, cap rates were near 2007 levels and the spread between cap rates and underlying Treasury rates was well above long-term trend levels. There was a presumption that the wide spread would allow some room to adjust cap rates, he says, but when interest rates spiked, most projects opted to use shorter term debt to offset the increase; rates were still near historically low levels, and banks were willing lenders.

e

What the Players Say About Interest Rates

Ralph Rosenberg
Global Head of Real Estate, KKR

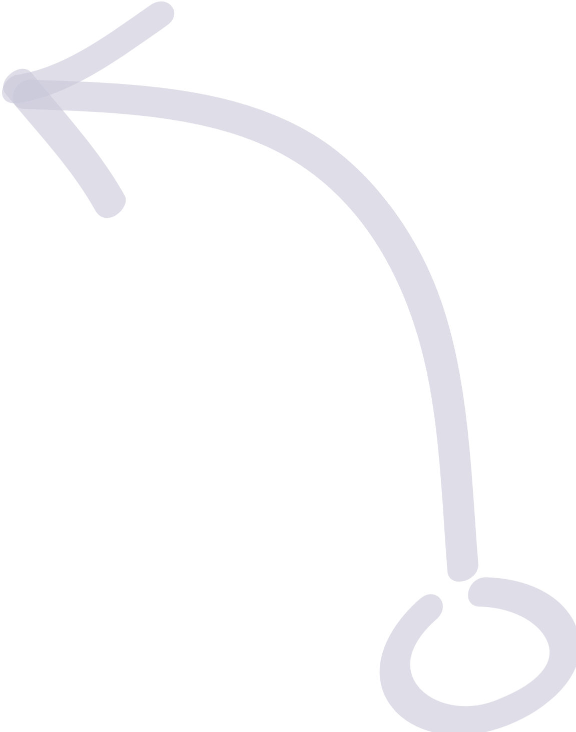
"If we see a surprising step-function move in the risk-free rate in the U.S. in 2014, that will dramatically impact real estate prices. Players in the market have effectively... allowed cap rates to compress quite dramatically. It takes a lot of [NOI] growth to compensate for cap-rate expansion.

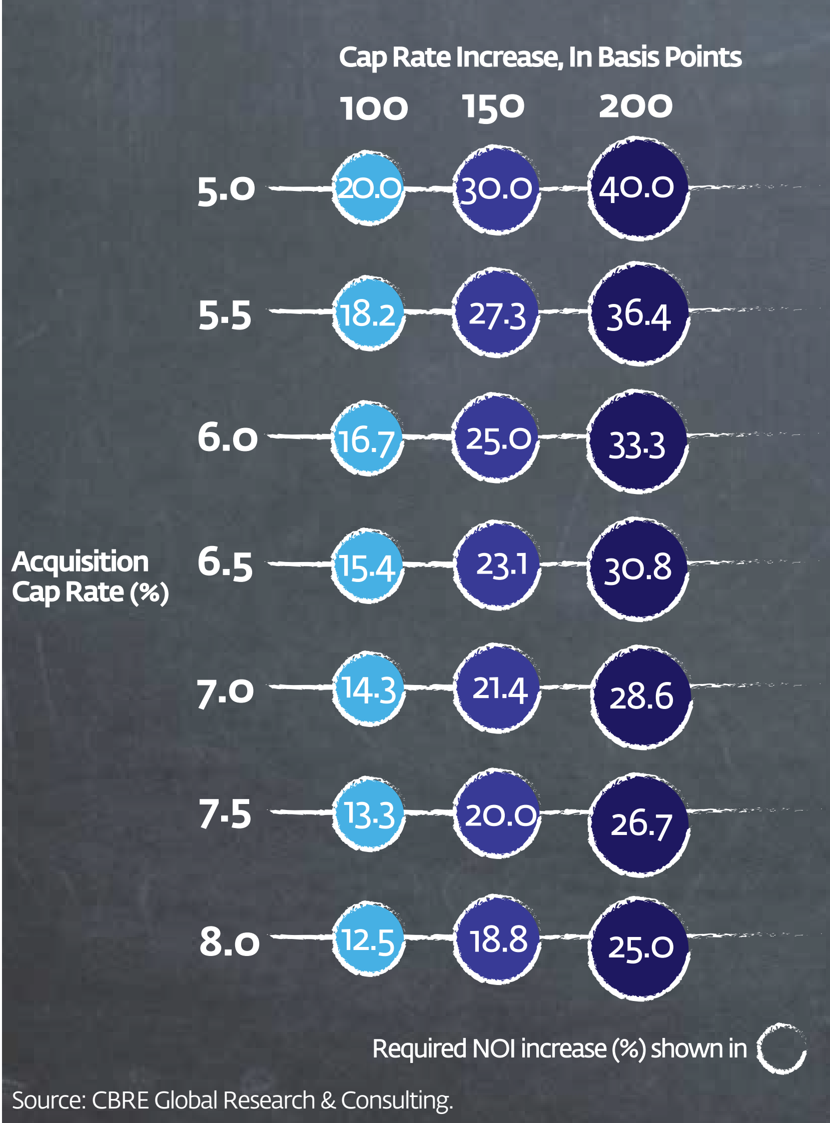


Play Watch our video round-up of expert predictions for 2014

How Much Extra Rent Will You Need?

How much additional revenue will you need to offset a 100bp, 150bp, or 200bp rise in cap rates? CBRE assesses the approximate revenue increase needed at various cap rates to absorb cap rate increases without diminishing terminal values.





Source: CBRE Global Research & Consulting.

How High is High?

There's little doubt interest rates are headed higher. As of mid-November, Goldman Sachs expected the key 10-year Treasury note rate to move to 3.25 percent in 2014, 3.5 percent in 2014 and 4 percent in 2016. Goldman's rate forecast reflects expectations for increasing GDP, consumer spending and business-fixed investment over the next three years. On the big question–when will the Fed start to taper–Goldman expects the central bank to start reducing its bond purchases in March of 2014. But concerns about the potential impact of another round of instability linger; Goldman cautions that the tapering decision could be delayed even longer if U.S. politicians engage in another round of fiscal brinkmanship.

Ultimately, rate increases would need to be justified by economic growth, says David Hale, whose firm, David Hale Global Economics, advises financial institutions and policymakers. Economic growth is the double-edged sword for the commercial real estate sector. Growth drives interest rates higher, negatively impacting cap rates, financing costs and asset values – but economic growth is also what enables landlords and asset owners to raise rents and boost NOI. And that's the crux of the amazing race.

What the Players Say About Interest Rates

Peter Braffman
Managing Director,
Grosvenor Customized Fund Investment Group

"[With] all the stuff we've been buying over the past few years that we expected to [sell] in the next few years, 2014 could be a problem. All of a sudden what [sellers] expected to be one kind of cap rate environment may be very different."

Sam Chandan
President and Chief Economist,
Chandan Economics

"We'll see a greater separation of folks who [can identify a] great opportunity and those who have depended upon very low cost financing."

Sonny Kalsi
Managing Partner, GreenOak Real Estate

"The big surprise in 2014 is going to be interest rates going up faster than anyone thinks. The market's not ready for that at all. We'll see a lot more defaults than people thought."

Prior to the crash, the Fed funds rate, which is the rate financial institutions pay to borrow directly from the Fed, was closely linked to the rate of nominal GDP growth. If U.S. nominal GDP growth were to normalize to a 4-5 percent annual rate, with inflation at 1.5 percent or more, Hale would expect the Fed funds rate to be between 4.5-5 percent by 2017, with the ten-year Treasury rate around 6 percent. But this recovery remains fragile, Hale says. Monetary policy is accommodative, corporate profits are strong, banks have built strong balance sheets, and the U.S. is benefiting from domestic energy production and a housing rebound. At the same time, services are weak, corporate capital expenditure is volatile, and housing remains vulnerable to up-ticks in mortgage rates. With that backdrop, says Hale, policymakers will act only when economic data confirms sustained growth, and in the meantime will maintain low interest rates.

The NOI Question

The subject of how much NOI growth is necessary to absorb an interest rate increase without impairing an asset's terminal value will become standard fare at real estate industry luncheons in 2014, says CBRE's Macke (see Table I). Like Wang, he sees an abundance of capital flowing to real estate. But location will matter, perhaps more than ever. He suggests clients undertake a careful analysis of how sensitive the cap rates in their real estate portfolios are to various interest rate changes – alongside an evaluation of the potential changes in NOI and cap rates within the specific markets where properties are located. San Francisco and San Jose are both expected to see office rents increase 30 percent by 2018, for example. With a 7 percent cap rate, San Jose's rising rents would appear to offer more than 200 basis points margin of safety to absorb a rise in cap rates, compared to about 120 basis points for the San Francisco market, with a 4.0-4.5 percent cap rate. But investing in San Francisco is a bet that the investment momentum of that market will continue, while investing in San Jose is a bet that actual rent increases will turn out to justify the anticipated margin of safety. For such markets, "you need to be more accurate in your forecast of NOI increases," says Macke.

At Clarion Partners, which advises pension funds, insurance companies and sovereign wealth funds, Tim Wang, the head of investment research, believes the economic growth pushing interest rates higher will allow NOI increases sufficient to offset value loss due to cap rate expansion. Wang's points to the market's behavior during 2013 as an indicator that the CRE sector is well-positioned for rising rates. When the 10-year Treasury rate moved up to 2.7 percent late in 2013 from 1.5 percent early in the year, long-term CRE mortgage rates rose by 30 to 70 basis points, "but we did not see any cap rate movement," he says.

The stability reflects three factors that favor commercial real estate, he adds. First is a structural feature that will enable real estate to keep pace with faster economic growth and adjust to rising rates – it's a hybrid asset, where owners have the ability to effectively adjust the coupon rate paid to investors by raising rents. Second, capital is flowing to real estate as institutional investors facing rising rates reduce fixed-income exposures and raise real-estate allocations, while overseas investors continue to buy large, well-leased properties in major markets. Finally, the cap rate spread over the 10-year Treasury rate shows that there's a significant margin of safety–late in 2013 the spread stood at 310 basis points, above the historical average since 1990 of 280 basis points.

While it's impossible to predict the timing or magnitude of interest rate changes, Wang says, it's also not practical to wait for expected rate changes to occur before committing capital to projects. He advises clients to price a measured increase in rates into underwriting and portfolio construction decisions–a 200-basis point increase in the 10-year Treasury rate over the next five years. He expects the Fed to begin tapering in 2014, and hold off on raising rates until 2015. But the impact of rising interest rates will vary across the real estate spectrum, he says, so it's vital for investors to tailor underwriting assumptions precisely to the time horizon of underlying projects; a value-add project with a three-year time-frame will look very different from a 10-year project that an investor plans to hold.

The word that best describes the CRE recovery since 2010 is "uneven," says Wang. "So flexibility is the key."/

Game Changer 2

Capital Flows

Cross-border investments will continue to flood the market in 2014, with Asian countries leading the way

By **Ainslie Chandler**

The biggest U.S. cities became a real estate battleground in 2013. Armies of wealthy offshore investors invaded core markets, determined to get a slice of the glistening trophy assets that grace their skylines—at almost any price.

Despite the soaring asking prices and the prospect of rising interest rates, the battle is expected to continue this year and spread further afield, with more investors, owners, financiers, and agents from all corners of the globe.

In 2013, Asian buyers won the upper hand, snapping up a number of trophy assets in key U.S. markets. Their appetite for global property is surging as the global property market has bounced back from the years of stagnation that followed the global economic downturn.

Adding to the competition for assets is the rise in the overall volume of private capital available for investment in prime property as investors raise their allocations to the asset class, becoming more comfortable with both investing overseas generally and in real estate specifically.

With the increased focus, however, comes concern that core assets are becoming overpriced. Investors are looking beyond the high-profile trophy assets in gateway cities, with interest intensifying in tech-focused cities, including San Francisco's Bay Area, Boston, and parts of New York.

Joe Kelly, director of market analysis at Real Capital Analytics, says that on a 12-month rolling basis, global capital (capital being invested outside its own continent) has continued to recover and is now around $80 billion.

"Still about half of what we saw at the peak of the cycle, but it's continued to recover quite rapidly," Kelly says. "Investors are looking to diversity not within their own continent but further afield. That's quite an interesting trend."

Following the Money Flows

Pamela Wright, managing director of Greenhill Real Estate Capital Advisory, says interest has been coming from a variety of offshore markets, including China and Korea.

Manhattan's towers held the strongest lure among U.S. cities for Asian real estate investors during 2013, Real Capital Analytics figures show. In 2012, the city attracted a little more than $1 billion in Asian capital. In 2013, it was the second-most-popular global destination, with $3.653 billion spent on nine deals. (London was the preferred city for Asian capital, attracting $9.230 billion in 50 deals.)

What the Players Say About Capital Flows

Marjorie Tsang
Director of Strategic Research and Solutions, New York Common Retirement Fund

"The mother of all tsunamis of capital will be coming onshore to the U.S. Whatever you've seen before, it will be really, really enhanced in 2014."

Play Watch our video round-up of expert predictions for 2014

Who's Buying?

Foreign Real Estate Investments in the United States, by Buyer Origin and Property Type

Source: Real Capital Analytics.
Notes: Capital flows for 12 months ended August 31, 2013. *Excludes the U.K. and Germany.

Korea's First Steps in Chicago

Jones Lang LaSalle's Bruce Milller on foreign investor interest in secondary U.S. cities, and why the Koreans are so taken with Chicago

South Korean investors are increasingly looking beyond the gateway markets for assets, according to Jones Lang LaSalle's international director, Bruce Miller, who recently helped a consortium including the Mirae Asset Global Investments Co. to buy Chicago's 31-story 225 West Wacker tower for $218 million.

"They were hungry to buy in the U.S. This was their first purchase in the U.S. They had looked in other markets, most recently in Houston, a few years ago back in San Francisco, and just had not found the right asset. And we were the right asset in the right place at the right time," Miller says, noting it was the third such trophy tower acquisition in the city by a Korean investor.

"In Chicago, what we've seen recently is, the Korean investors are the investors that have created a little bit of buzz here.

"We've not yet seen much interest from Chinese or Japanese investors in Chicago yet, although we do believe that's going to be coming in the relatively near future.

"There is an enormous amount of capital in South Korea that is looking to be placed, and it is, again, primarily in office product. We're starting to see a little bit of interest in multifamily product as well, and a little bit in retail product, but probably more in office than in anything else," he says./

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Singaporean groups had the biggest appetite for U.S. commercial real estate in the year to late November, snapping up nine properties worth $3.221 billion, according to RCA figures. Most of these deals can be attributed to the state-owned Government of Singapore Investment Corp (GIC).

Chinese investors followed, with $2.366 billion spent on 17 properties; investors out of Hong Kong have spent $6.666 billion on 79 properties. South Koreans spent $1.376 million on 27 assets, most of them funded by its sovereign wealth fund, the National Pension Service.

Behind the Numbers

Real Capital Analytics executive managing director Simon Malinson says Chinese capital has overtaken Middle Eastern capital in volume terms for the first time during 2013, particularly into Europe.

In an important shift, during the final months of 2013, the market witnessed some of the first trades by non-state-backed Chinese groups, he says.

Insurance companies and pension funds have been granted permission to invest outside China and are now rapidly deploying their capital, as they aim to diversify their portfolio and acquire better assets. This is particularly pronounced in Europe, Malinson says.

"We've seen it in the U.K. particularly. It's now expanding outside the U.K. And I think in the next few years the Chinese capital is going to be the explosion. We're going to see a huge wave of capital from China that's investing across the globe," he says.

Chinese groups have a preference for well-located assets with strong lease terms and good tenants, primarily from the banking sector, Malinson says,

What the Players Say About Capital Flows

Chris Keber
Senior Managing Director, Hines

"The capital flows from sovereign wealth funds will continue in an unprecedented dimension. China is going to lead the way with a wave of capital, such as we have never seen in private real estate."

Cheryl Boyer
Chief Operating Officer, Fulcrum Hospitality

"The globalization of investment into major markets like New York and San Francisco is going to...accelerate. The diversity of where the money's coming from is changing the face of real estate."

pointing to the recent sale of London's Deutsche Bank headquarters to a Chinese buyer.

Japanese buyers purchased only $72.9 million worth of U.S. property during the year-to-date. However, Tokyu Livable, Inc. managing director Charlie Haase says there is finally some appetite for offshore investment emerging in Japan.

Haase says there are institutional reasons for the stagnation, but some of the nation's sleeping investment giants, like the Japan National Pension Fund, are starting to wake and are contemplating getting involved in the fight for trophy assets. "These guys are finally looking at alternative investments, potentially including real estate, and on a global basis," he says.

Jones Lang LaSalle international director Bruce Miller says that though Asian buyers have been more active, there are a number of other major offshore players fighting for U.S. real estate, with Canadian, European (particularly German), Israeli, and Middle Eastern capital all joining the fight for prime property in key global markets.

RCA's Kelly said that around 2009, North America was the primary destination for Chinese investors. However, in recent years the United Kingdom and continental Europe had been the preferred markets amid concerns about tax laws, which had been a hindrance to cross-border deals.

"That basically taxes their profits relative to their income quite heavily," says Kelly. "So that can be a bit of a drawback." However, he says that they are still keen to get a foothold in major U.S. metropolitan markets, "looking at geographies and assets that can provide those larger lot sizes where they can build up portfolios reasonably quickly."/

Japan's Reawakening Appetite

Tokyu Livable, Inc.'s Charlie Haase on when and where Japanese investors are like to deploy capital

PrivcapRE
What is the appetite of Japanese investors for deploying capital internationally?

Haase
We're finally seeing some development in terms of the appetite for the institutional investors abroad, or even in real estate at all, since the 1980s and the glory days and the bubble burst in the '90s. They all realize that for the pension funds, they've got a growing number of retirees and a declining number of workers supporting that, and they're invested in Japanese government bonds that earn a zero. So everybody knows there's something to be done.

PrivcapRE
Which investors are actively looking for acquisitions?

Haase
There aren't so many institutional actors as one hopes there would be soon. There's a lot of studying going on. A lot of the actors are the corporate pension funds—they've been pretty active in the past—and some of the insurance companies, some of the banks. Everybody pulled back during the crisis, everybody did, and maybe the more adventurous or thoughtful ones are back out in the market now; over there, you need a leader to follow. What we're really hoping to see, frankly, is some of the larger funds, the trillion-dollar funds, make a move into alternative investments. And if that happens in any measurable way, everybody else will follow.

PrivcapRE
When the investors do come back to the market, where will they look for assets?

Haase
It'll be for the coasts. It'll be for New York, San Francisco, L.A. It'll be for class-A office first—maybe some multi-family residential for the more adventurous types, but the first step is always going to be class-A office./

Charlie Haase

Game Changer 3

GP Consolidation

Consolidation may mean fewer GPs in the industry, but that doesn't mean the industry players will stay the same. A Q&A with **David Hodes**.

David Hodes

PrivcapRE
Now that capital is returning to the market, are investors looking for broader mandates versus smaller niche players?

David Hodes, Hodes Weill & Associates
As large investors step up their real estate programs, they are doing so under the syndrome of trying to do more with less, meaning they'd like to deploy more capital to a smaller number of managers and counterparties. Why? Well, there is a resource constraint. If they can get a lot done with one relationship as opposed to setting up three or four, they'll shoot for a single relationship.

These large investors can also make a single large commitment to the very large alternative managers with programs in real estate, infrastructure, and private equity. The investors can do so and get very large economics, paying much lower fees while that large alternative manager can deploy capital across different alternative categories.

This beneficial dynamic between the large institutional investor and the single larger manager will continue, given that scale and establishing a global presence are now key. In the past, there was a preference for specialist boutique managers. But these managers were unstable during the calamitous financial times. As big investors seek to make bigger commitments to fund managers with broader, more global platforms, we expect to see more combinations whereby a manager will either absorb or merge with other management firms so they can have a broader array of product offerings.

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So what happens to the smaller, emerging managers during this shake-up?

Hodes
The ones that underperformed and misbehaved have already started to disappear. There is a sense that you lavish the most attention on your first-born while the subsequent children or funds may suffer from benign neglect. Emerging managers will always be a component of the industry, but the incompetent ones will disappear.

Investors are just a lot more cautious about who they back today. Investors need to be aware that some new managers haven't experienced a full market cycle to really appreciate the longevity of relationships, as well as the challenges of maintaining the stability of the program through good times and bad times.

Also, the cost of being in business is much more expensive today with compliance, reporting, risk management, and regulatory issues. The barriers to entering the business and reaching the billion-dollar critical-mass mark are higher than ever. Realistically, that critical-mass number has probably doubled today, given how long it takes to raise capital.

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What will drive mergers and takeovers?

Hodes
Initially, it was all about managers looking to counterparties—whether that was a strategic partner, a merger candidate, or an acquirer—to facilitate better, faster, easier capital raising. That has subsided; it's now more about the best way to grow and extend their global reach. There is an emphasis on scale as large institutions want to write a single check to a larger program.

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How will this wave of consolidation play out over the next two years?

Hodes
It will be common for two managers to realize they have aligned strategies and as a result will combine to eliminate duplicative costs and achieve scale. They'll just have to work out office politics—who's in charge of what and whose name is on the door.

Then there are the mega-mergers. If you look at the top tier, they are all in secure hands, but when you get to the top 11–30 range, there's an interesting dynamic at play. We're 20 years into the modern opportunistic real-estate private-funds industry. Many principals of these firms have been successful and have now reached a point of career transition. So here, the simple act of succession will probably force consolidation. /

What the Players Say About GP Consolidation

Michael Hoffmann
President and Managing Director,
Probitas Partners

"[Consolidation will] generate a whole new vintage of new GPs, some of whom will obviously go on to be the leaders in the industry."

Play Watch our round-up of expert predictions for 2014

Larissa Herczeg
Managing Director,
Oak Street Real Estate Capital

"The investor universe will be able to see some very successful emerging manager programs. People will see that these programs have been successful and the returns have been attractive, and that will cause a lot of new investors to start participating in the space."

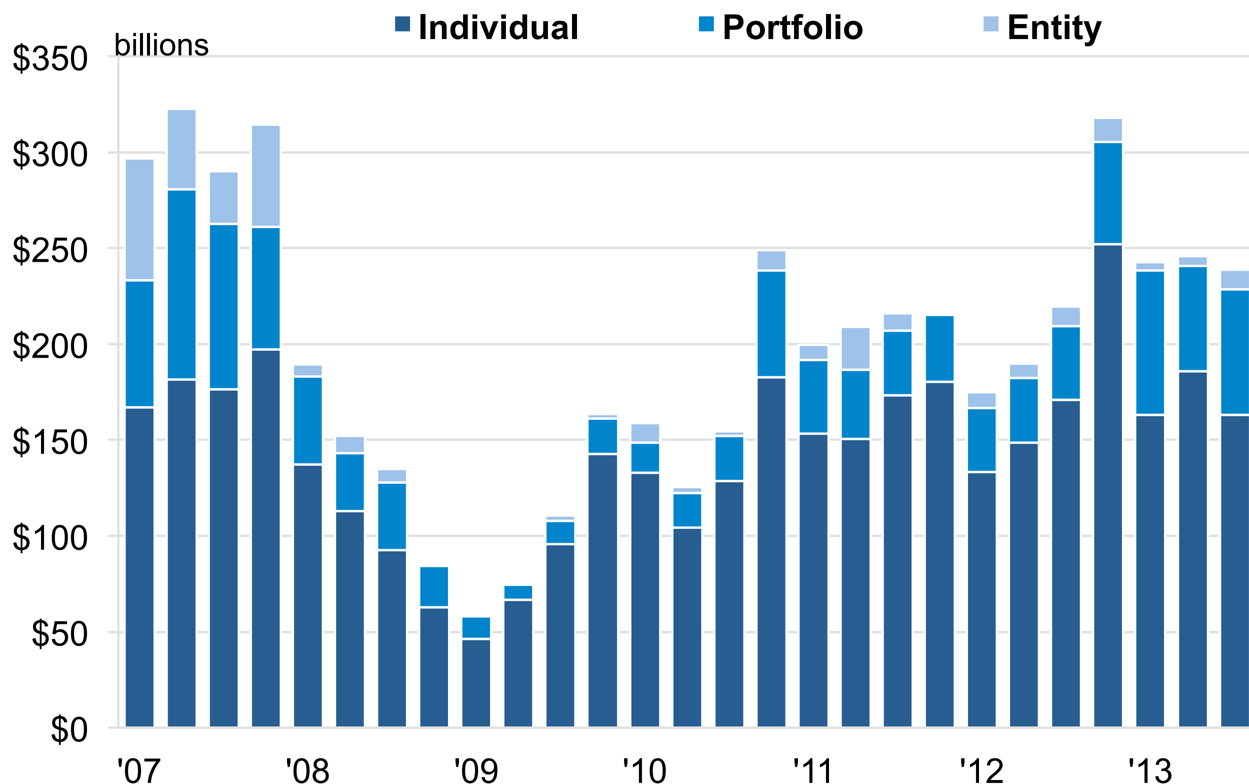
Performance by the Numbers

Data from the **first global fund index for non-listed real estate vehicles**—produced by industry associations **NCREIF, INREV, and ANREV** and data provider **Real Capital Analytics**—provides a **snapshot of global real estate market performance in 2013** and the biggest players in the game

A Global Comeback

Commercial property transactions were at their highest levels since 2007; expectations were that deals could top $1 trillion by year-end.
(RCA data as of Q3 2013)

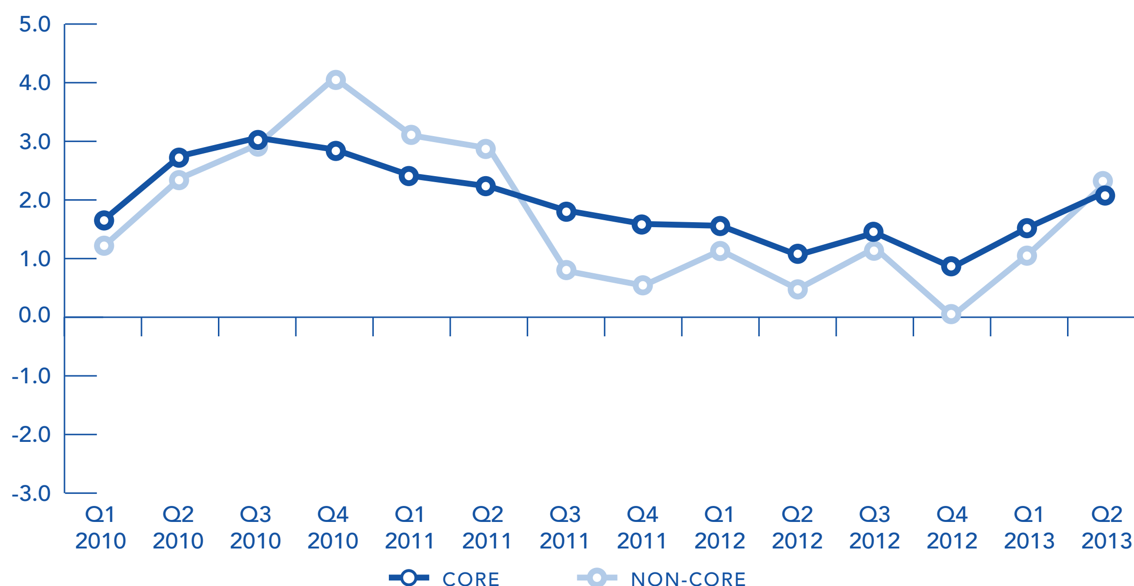
Quarterly Global Volume by Transaction Type



Core Performance

Globally, core outperformed non-core strategies in the first-ever index for non-listed real estate vehicles. See footnote. (NCREIF, INREV, ANREV data as of Jun 2013)

All Funds Index
Core vs. Non-Core Funds Indices



Regional Performance

Although not an apples-to-apples comparison, the performance charts indicate a strong real estate recovery in the U.S. during the past three years, compared to sluggish and declining returns in Europe. In the past year, U.S. returns began to outspace Asia's. (NCREIF, INREV, ANREV data as of Jun 2013)

Europe Total Returns % as of June 2013	1 year	2 year*	3 year*
Total	0.47	0.94	2.68
Core	1.02	1.56	3.07
Non-core**	-2.02	-1.81	0.88

*Annualized
**Only includes value-added funds

Asia Total Returns % as of June 2013	1 year	2 year*	3 year*
Total	8.64	7.28	7.28
Core	9.31	8.93	8.93
Non-core	7.33	4.24	4.24

*Annualized

US Total Returns % as of June 2013	1 year	2 year*	3 year*
Total	11.33	11.63	14.36
Core	11.08	11.19	13.85
Non-core	12.86	14.48	17.54

*Annualized
**Only includes core-plus, value-added open-ended funds

About This Research

The Global Real Estate Fund Index produced by NCREIF, INREV, and ANREV for the non-listed real estate industry is not a direct comparison of property performance across the regions. The index, which is in draft form and currently out for consultation until April 2014, includes data from core, core-plus, and value-added open-ended funds in the U.S.; core and value-added open and closed-ended funds in Europe; and core, value-added, and opportunistic open and closed-ended funds in Asia. Each group is currently enhancing its data collection to include higher-risk closed-ended strategies in the U.S. and Europe and core strategies in Asia. INREV research director Casper Hesp says the index is a "very good start, which provides institutional investors with their first global performance indicator. The index will be officially launched at the annual INREV meeting in Berlin on April 9 and 10, 2014, followed by expected quarterly updates.

The Ten Most Active Buyers

Blackstone was the most active buyer globally in the 12 months ending November 2013, acquiring **469 properties** for **$15.9 billion**. (RCA)

Rank	Name	Vol ($bn)	# Properties
1	Blackstone	15.92	469
2	China Vanke	12.31	86
3	Greenland Group	11.09	97
4	GIC (Govt of Singapore)	9.36	69
5	Equity Residential	9.10	86
6	Poly Real Estate Group	8.42	70
7	Norges Bank Invt Mgmt	8.13	105
8	China Overseas L&L	7.62	38
9	Spirit Realty Capital	7.47	377
10	Starwood Capital Group	6.60	230

In addition to buying high-profile stakes in London's Regent Street, in March 2013 a joint venture between Norges Bank Investment Management and Prologis closed on a $3.1bn, 38-property portfolio of industrial assets across Europe.

The Ten Most Active Sellers

Lehman Brothers Holdings was the most active seller globally in the 12 months ending November 2013, selling **411 properties** for **$34.4 billion**. (RCA)

Rank	Name	Vol ($bn)	# Properties
1	Lehman Bros Holdings	34.43	411
2	Blackstone	13.04	174
3	HK Lands Dept	8.81	36
4	GE Capital	8.65	302
5	Cole RE Investments	7.62	380
6	Goldman Sachs	6.62	85
7	Morgan Stanley	6.06	149
8	Deutsche Asset/Wealth	5.32	54
9	Fortress	5.17	194
10	Prologis	5.00	173

The $8.9B disposition of its Archstone apartment portfolio may have grabbed Lehman the headlines in 2013, but deals including the sale of a 55-property U.S. industrial portfolio to Blackstone for $430m helped elevate the bank to the top of the seller lists.

The Ten Most Active Markets

New York City was the most active market globally for transactions in the 12 months ending November 2013, with **$62 billion** of deals. (RCA)

Rank	Name	Vol ($bn)	Cap Rate
1	NYC Metro	62.03	5.62%
2	London Metro	43.29	5.56%
3	Shanghai	38.99	N/A
4	Tokyo	37.36	5.31%
5	LA Metro	30.22	6.31%

One of the notable Japan-based deals of 2013 was Fortress' purchase of the Sheraton Grande Tokyo Bay hotel in Tokyo's Disney resort. The $423m sale resolved a troubled situation for sellers Morgan Stanley Real Estate and Starwood Capital.

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The Bulls and Bears of Commercial Real Estate

David Sherman, president of **Metropolitan Real Estate**, on what's hot–and what's not–in global commercial real estate in 2014

David Sherman

DAVID SHERMAN

President & Co-CIO, Metropolitan Real Estate

Sherman has more than **25 years** of real estate finance and analytical experience. He is the current **Chairman of the Pension Real Estate Association (PREA) Institute Committee**. Prior to co-founding Metropolitan Real Estate, he ran D. Sherman & Company, Inc., an advisory firm focused on strategic issues and transactions in the real estate securities industry.

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When you look to 2014, what will be the key drivers of your strategies?

David Sherman, Metropolitan Real Estate
We'll continue to emphasize transforming underperforming assets into core-like assets that could be sold at relatively high prices. That means finding value, which means staying away from where that flow of liquidity comes in. It means avoid buying the trophy asset in West London or what everybody else is chasing. Instead, pursue the submarket next door, or buy a building that has a lease turnover—something that frightens other people. Partner with a manager that has the expertise to convert the property to core and sell it; that strategy should work well in 2014. We're assuming that overall pricing is relatively stable and you have to actually create the value by raising the cash flow. This means you have to be much more careful in market selection, asset selection, and manager selection.

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What are you bullish about next year?

Sherman
Office is usually the strongest-performing asset class before a recession, but as jobs are lost during downturns, office does the worst. You see a drop in occupancy. You see a drop in rents. You run into credit issues. Coming out, it usually performs the best, but we're not seeing this trend right now. And there's two

reasons. One is, job growth was more stagnant compared to past recoveries. This will correct itself over time.

The second drag on office is brand new and something I've never witnessed in my career. There has been a significant change in the nature of demand for office, and I think it's here to stay. If you look at New York, the recovery in demand would be in midtown Manhattan, the Financial District, Park Avenue, Fifth Avenue, etc. Rents there are recovering, but very slowly. We just signed a 10-year lease at a rent that's 27 percent less than the rent we vacated in midtown in a prime location. Meanwhile, in Park Avenue and Chelsea, the rents have gone from $30 a foot five years ago to $60 a foot today. The tenants in that market are smaller; growing, entrepreneurial companies. It means demand is in different neighborhoods. This makes for really interesting investment opportunities where demand is growing. It also means you must be cautious in traditionally exciting assets where the rents and occupancies aren't growing.

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Where do you see trouble?

Sherman

We're bearish in core, because we think it's generally overpriced. We're still very underweight in office, as we're just being cautious about where we invest.

We're beginning to reduce our allocation to multifamily, which has been fabulous in the U.S. for the last four years. During the post-correction, it had the best increase in rental occupancy rates and rental rates that I've seen in my career. That's primarily because after a recession, jobs are created. A young person gets a job, then an apartment. Secondly, we've seen home ownership go from 69 percent to about 64 percent in the country. It's a major drop, and the only drop in my lifetime. Every percentage point represents about a million households. Now the foreclosures are about done, job growth is about the same, and supply has started to increase. Multifamily won't be terrible, it will just flatten out. Therefore our allocation is decreasing. Our strategies have to have higher value-add to make sense.

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What are the key opportunities in Europe in 2014?

Sherman

We originally thought that maybe there would be a liquidation of bad bank inventories or nonperforming loans, quickly and large measure and at really cheap prices. It didn't happen. And it's not going to happen.

We see opportunities to recapitalize undercapitalized assets. Buildings that had too much debt and couldn't be renovated are coming back in markets like London, where they can now be deleveraged. We're taking advantage of things like lease rollovers and assets in transition, where we can come in with the problem fixed.

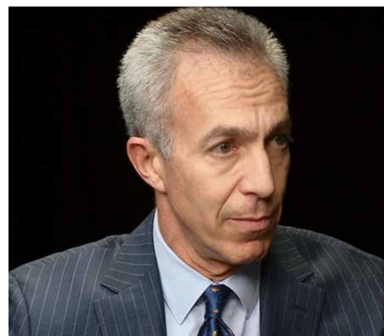
A year ago, we would have looked at Germany, France, U.K., the Nordics, and ignored the south. But Spain is on the verge of positive change. First, it appears it will remain part of the Eurozone come hell or high water. Second, there's the return of manufacturing jobs. Major markets like Madrid and Barcelona will benefit from this rebound in trade. Assets there will have long-term value. And if you can buy an office building in Madrid now at a huge discount compared to the square-foot values in London, Paris, or Frankfurt, that's pretty interesting, and we think that's going to become an opportunity in 2014./

Best of the Rest

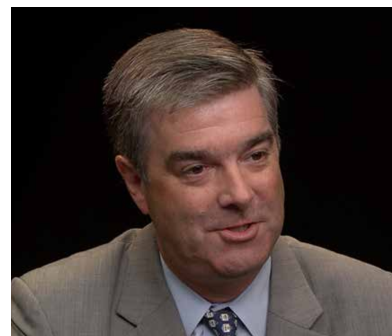
Interest rates and **capital flow** are not the only game changers expected in 2014. Our experts weigh in on everthing from technology to carried interest.

Thomas Barrack

Michael Levy



Michael Levy



Charles Purse

Technology

THOMAS BARRACK

Founder, Chairman, CEO, Colony Capital

""I think the game changer in front of us has got to be technology. If you look at what's happening with the proliferation of Wi-Fi, of broadband, of handheld devices, of delivery of information and services for the provider, that will be the winner of the trophy. That's a changed model. That's not the high-rise urban downtown city model, it's something else. And somebody will figure it out."

Emerging Markets

MICHAEL LEVY

Global COO and CFO, Morgan Stanley Real Estate Investing

"The volatility of the emerging markets clearly has concerned some investors. I think the flip side of that is that there is an opportunity...as investors are looking for contrarian investment opportunities."

Europe

CHARLES PURSE

Managing Principal, Park Hill Real Estate

"The scale of the issues that remain within the European banks is large...After dealing with the economic union, with cities that aren't the major center cities, and with the countries that still have significant debt issues—I think there's a lot more to hear about the scale of the challenge in Europe."

DAVID HODES

Managing Partner, Hodes Weill & Associates

"I hate to be surprised, but I think people will be surprised by the resurgence in Europe. With both capital going in, as well as investment opportunity—and not just in core Europe but some of the peripheral countries as well—we may see a better recovery than people are expecting."

Philip Marra

Peter Steil

Jeremy Naylor

Daniel Miller

U.S. Secondary Markets

PHILIP MARRA

National Client Leader – Real Estate, KPMG

"People focusing on the secondary markets. I think we will find that the Sun Belt and the Rust Belt will be exciting again, because people will be able to achieve more opportunistic-type returns in those marketplaces. The first movers in that space will be the big beneficiaries of the improvement in mainstream." People focusing on the secondary markets. I think we will find that the Sun Belt and the Rust Belt will be exciting again, because people will be able to achieve more opportunistic-type returns in those marketplaces. The first movers in that space will be the big beneficiaries of the improvement in mainstream."

U.S. Housing Market

PETER STEIL

CEO, NCREIF

"I think it's going to be the residential sector and the housing markets. I just think the housing market is ready, is at the cusp of coming back strongly, increasing construction markedly, and therefore being the second leg that leads to robust economic growth"

Carried Interest

JEREMY NAYLOR

Partner, Cooley

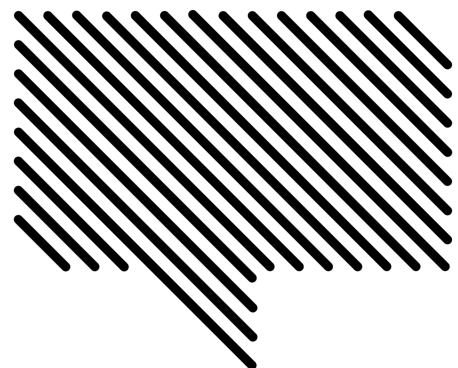
"Changes in the taxation of accrued interest would absolutely be a game changer for the commercial real estate market in 2014. That would really distort the way funds are structured and certainly could put a damper on the ability of general partners to raise funds, the ability of individual members of GPs to be willing to pay that extra tax [on] potential carried interest or promote in the future."

General Solicitation

DANIEL MILLER

Co-founder, Fundrise

"I think the biggest change is securities law. [With the JOBS Act] developers are now going to be creating brands around development companies. Developers with really strong projects, with really huge brands, are going to be able [to] raise much more capital and really separate themselves from the pack."



From the Archives

Explore PrivcapRE's vault of recent videos forecasting 2014's critical trends

Retrenchment and Opportunity in European Real Estate
Jeff Lefleur of W. P. Carey on deal flow

Europe's Periphery Comes into Play
Investors are turning away from ultra-core markets to peripheral countries—with some core investors even eyeing the distressed GIIPS

Real Estate Fundraising: Reconstruction and Revitalization
Michael Hoffman of Probitas Partners talks about the rising demand for credit and distressed-debt funds, GP reinvention, and Europe's repositioning play

From Defined Benefit to Defined Contribution
With Gretchen Perkins, Huron Capital Partners

Aberdeen Bullish on Mexico; Eyes Return to the Country
Aberdeen Asset Management is considering a return to a Mexican real after a five-year absence. The opportunities are great, but persistence is needed.

Real Estate Is About to Be Disrupted
Interest rates, technology and demographic changes herald change, according to Doug Poutasse of Bentall Kennedy

Housing Demand Drives Opportunity in China
With David Wilton, IFC

Rising Risks in Real Estate
Multifamily is deemed the gold standard of real estate investing, yet the sector faces significant challenges ahead, according to economist Dr. Sam Chandan

Solutions Financing in Automotive Retail

How a strategic partnership is helping auto dealerships monetize the value of their real estate assets

Click to watch this video at privcap.com

What is a triple net lease?
When the tenant is responsible for all costs related to the asset being leased, in addition to paying rent.

Last year, sale lease-back specialist W. P. Carey struck a deal with RML Automotive to acquire the real estate assets of eight U.S. automotive dealerships. It was the first of an expected series of similar deals in a space that both firms say represents a great opportunity.

For W. P. Carey, many automotive dealerships own great real estate and are great potential tenants. For RML, the deal represented an opportunity to unlock value and put capital to work in better way. According to Frank McLarty, CEO of RML, the Arkansas-based company had been growing strongly through acquisitions, and by 2012, "We wanted to continue to grow, so we looked for the best return on our equity investment. We also looked at the return we get on our operational investments versus the real estate—there's a substantial difference between the two."

Out of a desire to unlock the value of its real estate, RML entered into a sale lease-back transaction with W. P. Carey.

Jason Fox, managing director at the firm, says W. P. Carey carefully considers two elements when weighing a sale lease-back deal, first, the criticality of the real estate to the tenant, and second, the property's underlying, fundamental value. For many automotive dealerships, both of these boxes are checked.

Fox's team has found car dealerships, because they often sell new and used cars, are less impacted by economic cycles. Also, parts and services provide steady cash flow and cover 70 percent of fixed costs for the average dealership. W. P. Carey considers this element of stability attractive. "Few institutional investors are currently targeting this opportunity," says Fox.

According to McLarty, the sale-leaseback transactions bought out some other property owners, allowing RML to consolidate its landlord relationships into one lessor. "To have one institutional landlord whose interest is purely in being a long-term, triple-net lease landlord gives us the clarity and certainty we need to aggressively grow our business, whether it's by improving operations or acquisitions," says McLarty. "We can focus our attention and corporate resources on operating the business, not on complicated real estate negotiations."

In August, W. P. Carey completed a follow-on transaction with RML, acquiring a Toyota dealership in Texas for $15 million. The facility will be leased back to RML on a triple-net basis for 16 years.

According to Fox, W. P. Carey remains highly interested in automotive retail deals. "This industry meets many things we look for in a long-term net lease. Given the lack of institutional capital focused on only real estate in the automotive market, there are opportunities to find ways to invest money at good yields."/

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