PRIVCAPRE REPORT/

INSIDE:
- Value-Added, Opportunistic Outperformance
- The Best Vintage of Them All
- Benchmarking Risk in Real Estate

REAL ESTATE PERFORMANCE

Outperformance for value-added and opportunistic real estate in 2014, but how long will it continue?

With Expert Insights from:

Cambridge Associates
GCM Grosvenor
PREA

'Surprise to The Upside' on Strong Net Returns

It was a great time to be a real estate investor in 2014. Regardless of strategy or investment vehicle, public or private, the asset class has generated double-digit net returns for investors, even from core strategies that historically deliver mid-to-high single-digit performance.

The strong performance figures come on the back of improving fundamentals in the economy and, more importantly, unprecedented capital flows into U.S. commercial real estate markets.

What's different about the 2014 figures is that value-added and opportunistic real estate funds are starting to outperform their core and public counterparts.

As our panel of three industry experts from Cambridge Associates, GCM Grosvenor, and PREA discuss in this special report and accompanying video interviews, there has been a "surprise to the upside" when it comes to the continued strength of net returns across real estate, yet it is value-added and opportunistic strategies that are starting to outperform the pack.

But is a slowdown already on the cards? Most likely, our panel members say.

Of course, all this means that the best vintages are behind us in the current real estate cycle. As to which year will ultimately be declared the winner of the best vintage? The choice is tough, with 2009, 2010, 2011, and 2012 all standout years for value-added and opportunistic fund performance.

Cheers,

Zoe Hughes
Editor, Real Estate
Privcap
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In This Report

03
Strategy, Vintage and 2015 Expectations
Real Estate performance experts examine improving returns from value-added and opportunistic funds, and ponder what vintage will outperform.

06
Capital Flows Will Challenge Returns
Amid strong capital flows, looming risks, and rising asset prices, investors should temper return expectations.

07
The Importance of Testing Term Sheet Math
GPs need to focus on the language of their waterfall calculations to avoid LPs knocking at their door years later.

09
From the Archives
A selection of videos from PrivcapRE's archives.

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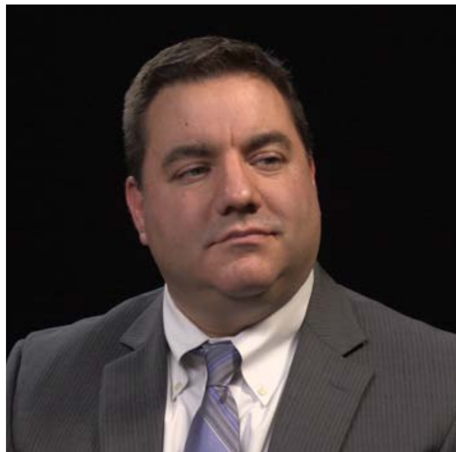
Strategy, Vintage and 2015 Expectations

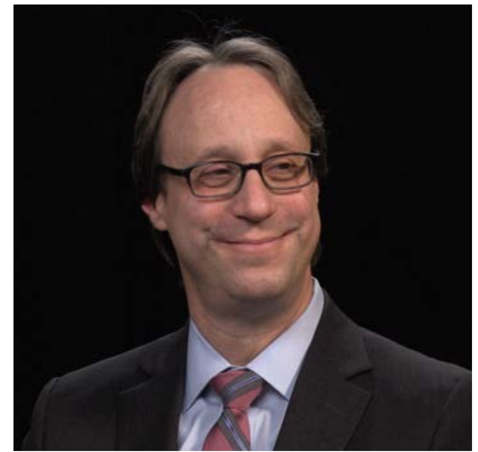
A panel of real estate performance experts examines improving returns from value-added and opportunistic funds, explores how higher-risk strategies compare to core real estate returns, and ponders what vintage will outperform them all

THE EXPERTS

Greg MacKinnon
Director of Research
PREA



Marc Cardillo
Managing Director
Cambridge Associates



Peter Braffman
Managing Director
GCM Grosvenor

➜ BIO

Prior to joining PREA, MacKinnon began his career as an academic, with his work published in the top research journals. He is a fellow of the Homer Hoyt Institute, serves on the board of the Real Estate Research Institute, and is co-editor of the *Journal of Real Estate Portfolio Management* and *The Journal of Portfolio Management.*

➜ BIO

Cardillo co-heads the hard-assets research team at Cambridge Associates, which covers global private investments in agriculture and natural resources, commodities, energy, infrastructure, real estate, and timber. Previously, he was an equity analyst at Gannett Welsh & Kotler. He is a CFA Charterholder and earned a B.A. from the College of the Holy Cross.

➜ BIO

Braffman leads the private markets real estate investment practice and is responsible for the group's real estate sourcing and underwriting activities. He is also a member of the investment committee for GCM Grosvenor Private Markets. Before joining GCM, Braffman was a partner in the Customized Fund Investment Group of Credit Suisse.

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Privcap: How has market performance for value-added and opportunistic real estate shaped up over the past five years?

Marc Cardillo: By way of review, the Cambridge Associates' benchmark comprises just under 800 funds—about 70 percent opportunistic funds and 30 percent value-added funds by market cap. For the third quarter of 2014, the [net returns] were just under 2 percent, and the trailing one-year return was about 15.5 percent; that's one of the higher one-year numbers we've seen post-financial crisis. That results in three-year and trailing five-year numbers of 10 percent to 11 percent, and I'd say relative to NCREIF.

Privcap: What are your expectations for numbers for year-end 2014?

Cardillo: With the third quarter, there was a little bit of deceleration relative to previous quarters, but I would expect the number to be between 12 percent and 14 percent for the year.

Privcap: Peter, as a multi-manager investor, how do you measure your portfolio's performance?

Peter Braffman: We look at it on a vintage-year basis. We do look at one-year numbers, but we're looking at them over a series of time and saying, "How is each vintage fund performing over three, four, five years, and what is their all-in return?" Each of the vintages since 2009 has been really strong. We're looking at net returns over that period of time compounded to north of 20 percent. That's extraordinary. What is interesting is that DPI, which is how much money's coming back – distributions – are very, very, very high. And I think what we're seeing is a continuing play on what's going on in the core market. The core market is remarkably heated, as is the core-plus market. A lot of capital is searching for yield. In the value-added and opportunistic space, [we] are selling into that market. The more we're selling into the market, [the more] we're seeing our returns being driven up, because we're able to exit these assets a lot sooner than we'd expected.

Privcap: Greg, PREA produces indices with IPD looking at open-ended, predominantly core—but also value-added—real estate funds. What are you seeing in terms of performance, and how does it compare to what Cambridge is seeing?

Greg MacKinnon: Well Peter mentioned that the core market was heated. It doesn't necessarily mean over-heated I don't think, but it's certainly heated, and that comes out in the numbers. On a gross-of-fees basis, [year-end returns are] almost 13 percent and net about 11.8 percent. So for core, those are pretty strong numbers. And the fourth quarter was a good end to the year. It was another strong return, with about 3.4 percent on a gross basis. So thus far, everybody knows the core market is heated, but there don't seem to be too many signs of that tailing off.

Privcap: Do you expect that strong performance to continue into 2015?

MacKinnon: I do not have a crystal ball, but we do surveys of [investors and managers], and they're looking at a slow decline in the returns going through 2015-2016. Not a reversal of the market, not a crash. The consensus forecast for this is 9.1 percent on an unlevered basis for core real estate, and then 8 percent in 2016. Those [returns]

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VALUE-ADD, OPPORTUNISTIC SHINE THROUGH

After lagging their core and public real estate rivals, value-added and opportunistic strategies, as benchmarked by Cambridge's Real Estate Index, are starting to outperform

INDICES	Net Returns YEAR TO Q3 2014	Net Returns 1-YEAR	Net Returns 3-YEAR	Net Returns 5-YEAR
Cambridge RE Index	8.4%	15.5%	11.7%	10.7%
NAREIT ALL Equity	13.4%	13.2%	17.2%	16.2%
NCREIF NPI	8.5%	11.3%	11.1%	11%

Source: Cambridge Associates

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Ensuring All Returns Are Risk-Adjusted

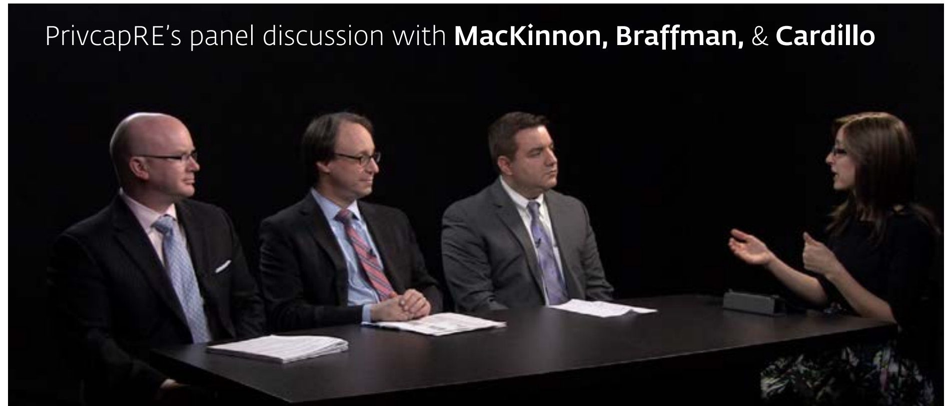
"Looking at the headline benchmark numbers...doesn't tell you anything about what level of risk a manager took to get there," says Marc Cardillo of Cambridge Associates, explaining how investors can achieve risk-adjusted returns across their entire portfolios.

Cardillo was speaking during a PrivcapRE performance panel discussion, together with Peter Braffman of GCM Grosvenor and Greg MacKinnon of PREA, who all agree there are several areas of focus that can help investors ensure that appropriate risk-management principles are guiding portfolio performance.

The most important thing in risk management, they all say, is greater GP transparency. By allowing investors a clear look at how assets are underwritten, they can better assess underlying risk. Braffman offers a sample list of value drivers, including measuring unlevered returns, tracking NOI growth and rent growth, and clearly understanding valuation methodologies, as areas where investors would benefit from applying greater due diligence.

While a move towards greater transparency has taken place in the industry over the past few years, there is plenty of room for improvement, with Braffman recommending that LPs "kind of force it to happen and say, 'Listen, if we're going to invest with you, you've got to report. Not just your returns, but your leveraged and your unleveraged returns, and a lot of other data points.' "

Such increased analysis undoubtedly impacts workloads, with Cardillo stressing it is vital for investors not to overreach their internal capacity by demanding more reporting than can be processed.



are closer to the long-term averages—about 9 percent over the last 30 years.

Cardillo: I think like Greg we're expecting some deceleration. And the numbers make sense given the weight of capital being raised for value-added and opportunistic funds. We still feel as though fundamentals are still pretty solid. And to Greg and Peter's earlier points, when we meet with value-added and opportunistic managers and we look at the recent transactions they've done or what's in their pipeline, they still seem to be finding stressed owners and finding good, traditional value-added opportunities.

Braffman: For the past couple of years, we've been talking to a number of our partners and they've all been saying that their return expectations could go down. That didn't materialize and I think it's largely because capital is driving it. We are seeing so much capital in the value-add and opportunistic sector [being distributed back] so soon...that capital will go back into these markets and that will mean more price appreciation. So I think returns are going to be very strong over the next year or two.

MacKinnon: It's funny, if you look at our consensus forecast that we put out over the last few years, this idea that returns next year will decelerate has around for two and-a-half years. But every time another quarter of really good numbers comes out, people say well, maybe it'll be the year after that or the year after that [that returns decelerate].

Privcap: So, are the best vintage years already behind us in this real estate cycle?

Cardillo: We recognize these next few vintage years won't be as strong as [those] coming out of the financial crisis, but will they be decent years, or are we looking at a lot of clients who are loath to repeat the mistakes they made in 2004-2005 [to] experience those types of returns? Hopefully those returns won't be repeated. But it's fair to say that the best returns are a few years in the rearview mirror.

Braffman: I'd probably pick 2011. It's going to be a strong vintage period. But 2010 and 2009 look really, really good. We saw some 2009s that were just out of control. We're getting returns from that vintage that really aren't normal [or] realistic. If you look at it from a risk-adjusted basis, the returns that we'll get from 2011—but maybe also 2010, 2009, 2012—are going to be better, because most of our managers were able to buy cash flow. So the result is, these things were performing out of the box, and that's going to be different going forward. ■

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Capital Flows Will Challenge Returns

Amid strong capital flows, looming risks, and rising asset prices, investors should temper return expectations

Greg MacKinnon
Director of Research
PREA

"We are looking at what's probably going to be a slower environment going forward, driven mainly…by capital flows and interest rates."

–MacKinnon

Capital flows into private real estate are set to continue for the foreseeable future, putting additional pressure on rising valuations and ultimate returns for investors and managers.

A PrivcapRE panel featuring experts from Cambridge Associates, GCM Grosvenor, and PREA agree that myriad factors such as interest rate fears, economic concerns, and global investors in search of safe havens will continue to fuel investment in the real estate asset class and drive the bidding up of assets.

"There's a lot of capital looking to [invest in] property, and that has driven prices up and has compressed returns," says Greg MacKinnon, director of research at the industry association PREA. "We are looking at what's probably going to be a slower environment going forward, driven mainly…by capital flows and interest rates."

With rising demand for commercial real estate, LPs and GPs are worried about risk management and where certain markets are positioned in the real estate cycle. "If you're buying today, there's no doubt it's at a higher price point than a few years ago," says Peter Braffman, managing director with GCM Grosvenor.

Alongside the impact of capital flows into the asset class, Braffman also highlights concerns about debt driving up asset prices. "Debt tends to move the markets," he says, adding: "There's going to be a correction at some point. So that's the thing to watch out. If debt retracts, that'll be a problem." He also takes a focused approach to his views of the cycle. "It depends a little bit on the markets and the asset types," he says, with retail and industrial currently more attractively priced than heated sectors such as multifamily and hospitality.

With regard to the daunting possibility of interest rate increases, Marc Cardillo, managing director of Cambridge Associates allays some concerns, saying: "It does seem like any rise, whenever it starts, would be fairly gradual. I've seen different studies that indicate that real estate in the past has done reasonably well in periods of rising interest rates."

But while risk is a concern, there are reasons to believe strong real estate performance can be achieved. "I know when people say, 'This time is different,' the warning bells go off," says MacKinnon. "But this time, I actually do think it's different. We [don't] see any oversupply." For Cardillo, improved use of leverage by managers will also make a marked difference.

Ultimately, though, investors need to temper return expectations in their effort to achieve the best risk-adjusted returns. "Some LP expectations probably aren't realistic, because the numbers that managers are quoting may be more marketing than real honest assessments," says Cardillo. MacKinnon adds a positive note, saying, "[Industry] expectations right now are more realistic than they used to be."■

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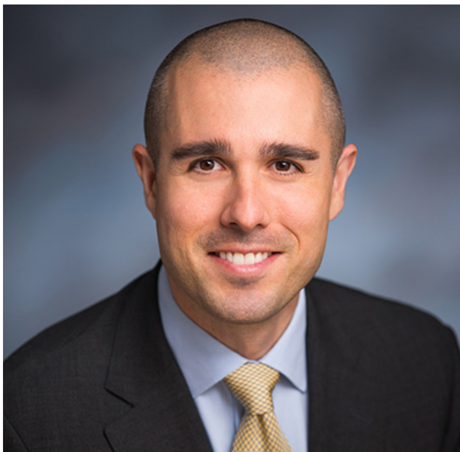
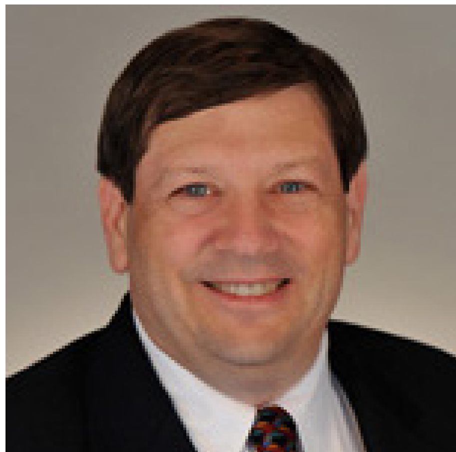
The Importance of Testing Term Sheet Math

GPs need to focus on the language of their waterfall calculations to avoid LPs coming knocking at their door years laterv



Dillan Lorda
Principal
PCA



Roy Schneiderman
Director of Research
PREA

> **"Missing the mark on fine print can lead to a great deal of friction."**
>
> –Roy Schneiderman, Bard Consulting

By Olin Monty

Investors and managers can spend dozens of hours negotiating a working waterfall profit distribution model. However, a failure to pay attention to specific term sheet language can cause trouble years down the line and impact the alignment between general partners and limited partners.

"A term sheet will often be in the range of several pages, with somewhere between a few lines and a few paragraphs on fees," says Roy Schneiderman, a principal at Bard Consulting. "The problem is, once the term sheet is hammered out, people sometimes go on autopilot."

Schneiderman points out that problems often occur at the point where term sheets are converted to full-fledged legal frameworks. It's a problem that has put many LP-GP relationships out of alignment at the outset, but changes in process could help lessen the heartache.

Once term sheets are completed, the actual waterfall structuring is often passed on to legal advisers, with little oversight thereafter. "Missing the mark on fine print can lead to a great deal of friction," says Schneiderman, referring to fund, venture, and operating documentation that, if too general, leaves remaining stakeholders open to interpret ambiguities.

One fund manager, commenting on the challenges of executing on loose documentation language, says, "The hardest thing to wrap our heads around is the nuances in our waterfalls. When you think of expenses...you have to wonder if your investor is interpreting them the same way. We've had a time when we were literally off by pennies, and we got a knock on the door."

Among strategies for investors, Schneiderman recommends avoiding boilerplate language, as it can contrib-

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> **"When terms and calculation methodologies are not fully vetted, issues are discovered years down the line when the waterfall models are actually run."**
>
> –Dillon Lorda, PCA

ute to an "autopilot mentality" across all relationships. "Specificity matters, and it's important to focus on the definitions, models, and the precise math used," he says. "As an example, a 10 percent preferred hurdle and a 10 percent IRR are not always the same, but some analysts will treat them as synonymous." He underscores the need for investors to seek clarification on asset management fee provisions that include definitions such as unreturned equity versus invested capital.

Testing is also critical at the outset. Stakeholders often do not test the math in their waterfall structures, nor do they test the various iterations of scenarios that can occur, especially those situations that can affect hurdles. Schneiderman recommends strong testing up front, along with a level-best effort to record the math, examples of its application, and situational examples in the documentation.

Of course, the biggest problems rear themselves after the fact. "When terms and calculation methodologies are not fully vetted, issues are discovered years down the line when the waterfall models are actually run," says Dillon Lorda, principal at consultant PCA, highlighting the tail end of investment life cycles when profits are realized and distributed.

"Years after the terms were negotiated and language [was] drafted, the people who have to interpret the language are often not the same," Lorda notes. "So the language might not be interpreted the way it was originally intended." Instead, he recommends the use of "blind-eye testing" to validate incentive fee language and structures, whereby an analyst or other third party not involved in the negotiations runs cash flow models based on the specific language used. "Without using examples, [this analyst/third party] helps ensure the language accurately reflects the intentions of the people negotiating the terms, based on documentation language alone."

More than ever, investors are adding advisers to their talent pool to tackle the waterfall conundrum. Specialists are being employed to reduce the litany of loopholes that can occur in fees, structuring, and documentation. One prominent pension fund portfolio manager says that waterfalls have been the most difficult topic to educate their team on and agrees that consultants have offered a huge lift, though risks are always present.

Ultimately, Schneiderman says, "recognize you haven't finished when completing the term sheet. It's important to pay careful attention to the legal documentation and make sure to include one or more examples of how the waterfall will work."■

REAL ESTATE
GAME CHANGE
2015

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From the Archives

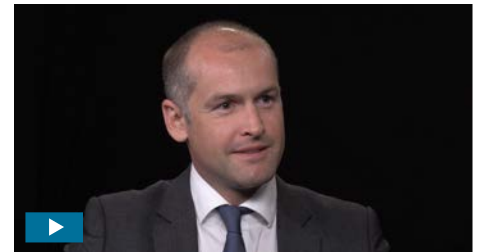
Institutional Portfolio

UPS Eyes Deal Control, JVs, Debt
Greg Spick of UPS discusses its asset allocation assumptions and the role real estate needs to play in a corporate pension plan.

How to Avoid Being a Passive LP
Siguler Guff's head of real estate, James Corl, details how multi-managers have improved LP governance rights by taking back some GP discretion.

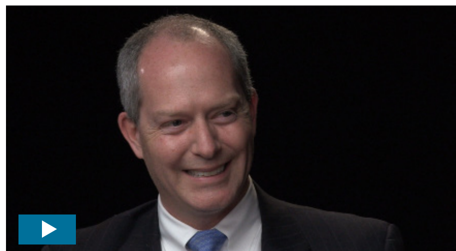
Deals & Capital Markets

Risk-Taking the Dune Real Estate Way
Dune Real Estate CIO Cia Buckley Marakovits talks about concentration risk and the impact on its fund and investors of doing just four or five deals a year.

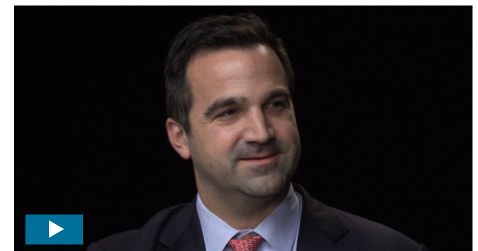


Union Eyes $2B of Investment
German fund manager Union Investment is looking to invest more than $2B of co-investment equity in the Americas, says its head in the region, Thomas Gnieser.

Debt



Growing Cornerstone's Debt Platform
Robert Little, Cornerstone Real Estate Advisors' CIO for finance, talks about the firm's expansion plans beyond senior fixed-rate lending in London.



Targeting Hotel Distress After the Crisis
Rockbridge CEO Jim Merkel discusses the U.S. hospitality market, average room rate growth, and the firm's play in hospitality debt and equity.

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