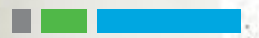


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About Privcap

Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap offers communications services to market participants.

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Richard Edelheit

Partner,

National Real Estate Lead,

RSM US LLP

Searching for Opportunity, as the Cycle Churns On

Ask real estate investors where we are in the cycle, and most will tell you we're closer to the end than the beginning. That, of course, has significant implications for evaluating opportunities and navigating risk.

We, along with our partners at Privcap, created this report to help you understand what some of the best real estate investors are doing as we all continue to transact in very uncertain times. The issues are unquestionably broad and challenging—valuation, taxation, global capital flows and economics, debt and leverage, and deal dynamics that vary widely sector by sector and market by market.

No one in these pages pretends to have all the answers, but they do provide the context to help you make better decisions and, ultimately, make more money. In a business where information—and timing—is everything, it's imperative that we all look beyond our own networks for fresh ideas. We trust this report provides plenty of them.

Regards,

Richard Edelheit

RSM US LLP

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Where Amherst Sees Single-Family Values



Sandeep Bordia

Head of Research & Analytics,
Amherst Capital Management

Strict lending and high demand mean that today and in the coming years, some markets are far better values

Privcap: What is your basic investment strategy?

Sandeep Bordia, Amherst Capital Management: To buy single-family homes for rental. Once they are rented, we lever them up.

How large is your portfolio?

Bordia: About 2,500, 3,000 properties in the single-family equity fund. We have a large number in Texas; we generally look outside the “first-tier” locations like New York and San Francisco. Secondary cities like Nashville, Tennessee; Charlotte, North Carolina; Atlanta; Boston; Houston—those are the areas where we have the biggest focus right now.

Are these properties mostly in foreclosure or in some kind of trouble?

Bordia: We buy properties both through foreclosure as well as the regular MLS listings. But the portfolio is really comprised of stabilized properties. Our fund would typically invest in properties that are 80 percent, 85 percent, 90 percent stabilized. So they’ve already been rented, and you are generating an income of, say, 5 percent, 5.5 percent, 6 percent on a cash-on-cash return basis. It’s like any other income-generating real estate asset.

I assume you’re not buying one-offs. Are you buying portfolios?

Bordia: We are also buying one-offs. We have invested a lot in technology. We have a sister company called Main Street Renewal,

which is part of Amherst Holdings. We are able to bid on the properties that we like in a very efficient manner.

Just to give an example, if a few hundred listings appear one day in some of the target markets that I mentioned, that night we download information on all of those properties into our system. We have invested a lot in technology in terms of looking at those properties, looking at the census tract information, running our models. There is a lot of human touch required in all of these things, but the technology helps us make sure that the investment professionals are spending pretty much all of their time on things that matter the most.

If we get a listing today on a property that we like, we can typically turn around all the manual work and run all the models and send out an offer the next afternoon.

What are your investment parameters?

Bordia: We have strict parameters. For example, we only buy three-or-more-bedroom properties constructed after 1978. The typical price point is in the \$125,000-to-\$150,000 range.

And what is the competition like? Do you find yourself up against a local guy who wants to buy a house to move into? Or are you bidding against other institutional investors or other non-institutional private investors?

Bordia: Institutional investors still are a very, very small part of the single-family rental market—only around 1 percent to 1.5 percent. More often than not, we are competing with other people who are actually going to own the homes and live in them, or regular investors. Historically, retail buyers could buy these properties at really low cap rates. Today, they don’t really have the kind of financing that they need. As an institutional guy, you have

access to financing that is much better suited for these kind of investments. You can get five-year, 10-year loans at much more attractive rates than an investor can—especially if that investor is not a very high-FICO, pristine-quality borrower.

How are these typically financed?

Bordia: The typical structures that we have seen in the marketplace are financed anywhere between 60 to 70 percent of the total purchase.

Do you plan to hold these for the long term?

Bordia: Yes. Our strategy is a little different from Blackstone and some of the others. There are two ways that you make money in this. The first is the cash flow income—the 5.5 percent to 6 percent cap rate. And you also have home price appreciation over time. So if you own the property for three years, and home prices go at the rate of 3 percent per annum, then you get another 9 percent cumulative return over the next three years.

How do you see the market right now?

Bordia: There are still quite a few areas that look very attractive—Chicago, Indianapolis, Cincinnati, Nashville, Charlotte. In all of these, you can still buy properties with cap rates of 6 percent to 6.5 percent. One reason we think this is a good investment is because in the medium-to-long term, we don’t expect mortgage credit availability to come back. As a result, the demand for rentals is going to get really high.

Finally, you layer on the benefits that institutional investors have over mom-and-pop investors. It really looks to me that the industry is going to do reasonably well over the next several years. And the opportunity is not going to vanish. ■

How Institutional Investors Find the ‘Right’ Partner

Former DuPont Capital Management real estate head David Julier argues that it’s critical for LPs to underwrite the personality and mindset of the GP they invest with, and for that manager to act as an extension of the LP’s office

When a limited partner is evaluating a potential investment manager, the GP’s mindset matters most.

“That’s what will carry the day,” says David Julier, an independent consultant and former real estate director of DuPont Capital Management, particularly given the current reality of more than 500 closed-end funds in marketing mode. “You want somebody that acts as a partner in its truest sense, that has the mindset that ‘I, as a GP, am an extension of this institution’s office.’ It’s that type of mindset that you’re really looking for as an institutional LP investor.”

Julier—who ran DuPont’s \$1.2 billion commercial real estate portfolio for nine years until December 2015, investing in more than 25 GPs—says LPs can underwrite a mindset by spending more time on the ground with their GPs.

“It’s understanding their thought process. It’s watching them operate—how they review an asset or walk the property or do community surveys,” he says. “It’s really watching them interact with others in the industry and then taking your collective experience as an investor and saying, ‘Is this person doing something that I think is better than somebody else, consistent with what I’ve seen before?’”

Julier is now advising smaller investment managers on their platforms and strategy, and says it’s also vital for managers to understand where they fit into



the LP portfolio—not just in terms of real estate allocations, but for the plan’s entire portfolio.

“You have to understand where your fund, where your strategy, fits into the broader context of not just a real estate portfolio, but in that portfolio of the foundation, endowment, pension,” says Julier.

As far as current real estate opportunities in the U.S., Julier is cautious. That’s because of the prospect of rising interest rates and the question of whether current valuations are pushing acquisition teams beyond their mandates.

“The concern I would have as an LP is whether general partners, in an effort to achieve stated returns, start to creep into secondary and tertiary markets,” he says. “Are they starting to take on a higher level of risk than what they had stated in their presentation materials and offering memorandum?”

“And that comes back to mindset and understanding my manager, seeing what’s happening in the portfolio, understanding the bricks and mortar. I want to be that close to it, because I want my manager to act like an extension of my office.” ■

Real Estate:

Is the Chinese Capital Boom Coming to an End?

Private equity real estate firms have witnessed a crackdown on Chinese entities getting capital out of the country, potentially limiting exits and investment partnerships

In recent years, an influx of Chinese capital has been a welcome new development for private equity real estate funds selling their U.S. holdings amidst an aging boom cycle.

Those heady times may be coming to an end, as Chinese authorities are increasingly taking action to stem currency outflows. Political instability isn't helping matters, either.

Tom Mills, head of U.S. investment at Cos Capital, confirms: "We have seen a tightening over the last year."

In November, China's State Council reportedly reminded government departments of regulations to sanction foreign real estate transactions of over \$1 billion. Should the government stringently follow the directive, it could significantly reduce exit routes and investment partners for U.S.-based funds. Indeed, it already seems to have had a negative effect upon some private equity real estate players, operating partners included. In talking to various sources, Privcap has learned of instances where Chinese entities have nearly failed to transfer funds to sellers in time for the day of closing a transaction.

An Active Market, Going Cold?

U.S. private equity firms have unquestionably benefited from Chinese asset flows, as a weak yuan and low domestic property yields pushed investors to look abroad.

The Blackstone Group, the largest private equity real estate platform globally, found success with hospitality assets. Blackstone sold Strategic Hotels & Resorts for \$6.5 billion to Anbang Insurance Group in what turned out to be the largest corporate deal in 2016 by a Chinese group, across all U.S. industries. NorthStar Realty Finance struck a deal to sell a 19 percent stake in a healthcare property portfolio to Taikang Life Insurance for \$1 billion.

Such gargantuan dealmaking in 2016 helped catapult China to become the largest foreign buyer of global real estate last year, according to JLL. In total, Chinese entities invested \$33 billion overseas, with the U.S. being the most popular destination. China Life Insurance and China Investment Corporation have been among the biggest investors.

The Reality Today

Cos Capital, which is a joint venture between its partners and China Orient Asset Management, has made six investments in three years in Chicago, Atlanta, San Diego, and Charlotte, North Carolina; it is on the brink of closing a seventh. It has been selling down stakes in China Orient's first three U.S. real estate deals to other Chinese institutions and wealthy private investors.

Says Mills: "We have seen things change to the point where we are no longer even talking to parties if they have all their money onshore in mainland China, because it is nearly impossible to get that out. It's partly Chinese authorities trying to stop the Chinese currency depreciating further."

China Orient, incidentally, manages to sidestep restrictions by investing with Hong Kong currency via a subsidiary.

Mike Hu of private equity real estate firm Gaw Capital, which owns \$2 billion of U.S. assets, says Chinese investment in the U.S. has slowed since changes in regulation. Towards the end of last year, Hu says, it was clear that some Chinese capital was rushing to complete transactions. "It's really now a 'wait and see' game for a lot of Chinese investors in terms of how easy it will be for them to get their capital overseas."

While investment volumes for the first half of 2017 might turn out to be below 2016, real estate professionals say regulatory tightening could be a short-term barrier, and that the longer-term trend will continue to be Chinese investment in U.S. real estate.

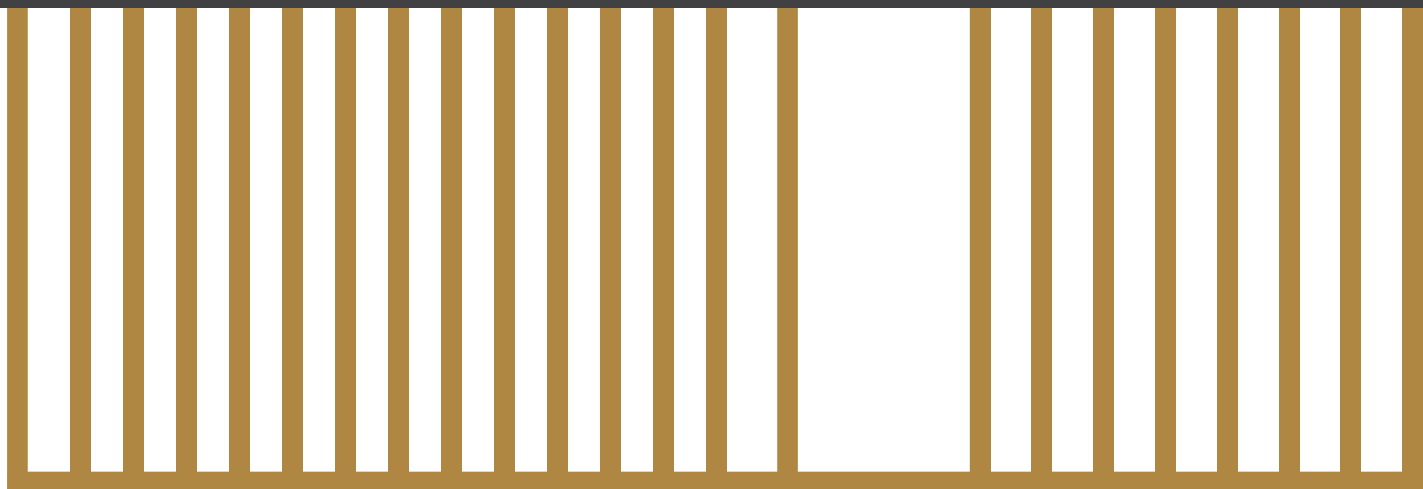
Apart from Chinese regulation designed to choke off investment in foreign real estate, there is also the question of geopolitical changes following Donald Trump's election as U.S. president. At a ULI real estate conference in Paris recently, Dr. Robin Niblett, director of a think tank, Chatham House, told delegates Trump's policy was to "contain China."

Signs of protectionism surfaced even before Trump's presidency. The Committee on Foreign Investment in the United States blocked The Blackstone Group from selling one hotel in its Strategic Hotels & Resorts portfolio last year. The Hotel del Coronado, near a naval base in San Diego, posed a possible security risk. However, most people say it is too early to make a call on the impact of evolving U.S.-Chinese relations. ■



Inside Real Estate

With RSM's Michael Schwartz



Privcap: As you look ahead, will the globalization of real estate capital continue?

Michael Schwartz, RSM US LLP: It will continue to stay strong. And that is because a lot of foreign investors are somewhat closed in their own markets. Over the last five years, they've been very active in the U.S. market, as it's viewed as a stable real estate market with consistent rules. It's also a market with considerable diversity in terms of asset types and geography.

The Chinese obviously have been very active. Singapore's sovereign wealth fund has been very active. Abu Dhabi has been very active in both the U.S. and Canada, as have other foreign buyers. Of course, the gateway cities have always been hot. Over the last number of years, New York, Boston, D.C., San Francisco, L.A. ... You're now seeing investments in other cities, such as Miami, by these foreign players.

The year 2018 will be interesting. Will they continue at this rate? I think they will. The problem and—no pun intended—the trump card may be the new Trump administration.

Michael Schwartz
Principal,
RSM US LLP



“We’ve seen debt players walk away from loans more in the last three to five years than they did in the seven, eight years leading up to the crash. And they’re tightening standards.”

—Michael Schwartz, RSM US LLP

Where things are going to go with them now issuing executive orders eliminating a lot of the trade agreements with Asia, Europe, etc., is an open question. But I suspect there will be a response, particularly in Asia. Are they going to say, “Well, forget it, we’re not going to invest in the U.S., we’re going to go to Europe now”? Of course, England has their own issues with Brexit. Are they going to invest there? That’s going to be an interesting play. So, again, my gut is they will still continue to invest. But a lot of it may be hinging upon where the new administration is going to play in the world markets.

Has the demand for “trophy” assets by foreign investors distorted that market?

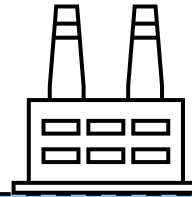
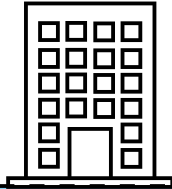
Schwartz: It has to some degree, sure. In the gateway cities—New York, San Francisco, in particular—over the last three to four years, cap rates have gone down and rents have gone up. They’re still very hot and they’re still good investments. But what you’re seeing is, now if somebody wants to invest and get a 4.5, 5.0 cap in one of these cities, they might instead go for a 6.0 or 7.0 cap in some of the in-fill cities like Miami or even these new millennial “18-hour” cities such as Nashville or Columbus. We’re seeing some investment there from some foreign players.

What do you predict by way of underwriting standards in a rising-interest-rate environment?

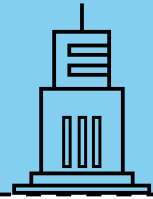
Schwartz: First of all, rising interest rates have already been incorporated into a lot of investments. And a lot of the debt players have factored these in, going back to even starting in the middle of 2016, before rates crept up at the end of the year. I believe they’ve already factored in a quarter to a half a point increase in rates. So that’s not quite as big of an issue. However, underwriting standards are still being scrutinized.

The question is, have we learned from our mistakes? Did we learn from the RTC bailout in the early '90s, the blip in 2001, and then, of course, the Great Recession? And I think underwriting standards have improved so much in the last few years. We’ve seen debt players walk away from loans more in the last three to five years than they did in the seven, eight years leading up to the crash. And they’re tightening standards. You’re seeing loan-to-value ratios on some buildings as low as 50 percent, with 75 percent still being standard. Leading up to the crash, they were as high as 90 percent.

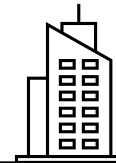
Let’s talk on the residential side, too. Same thing, underwriting standards are so strict that a lot of folks can’t qualify. They’re renting, but that’s helping the Blackstones of the world, because they’re the biggest investors in rental properties. So we’re seeing underwriting standards continue to increase. And maybe we have learned the lessons of the past. ■



Property Management Looks to the *Future*



As real estate funds look at their portfolios and tenants, whether they're high-end office lessees or residents of multifamily apartment buildings, the future will be one of fundamental shifts



Investors can see the future and value of property management, and how it can create and add value to portfolios and tenants. Investors recognize that the difference in a highly competitive marketplace is the quality, business focus, and strategy of their property management team. As we head toward 2020 and beyond, real estate funds and investors are making a fundamental shift from a purely asset-centric to a combined asset- and customer-centric business model, says Christopher Lee, president and chief executive officer of the consulting firm CEL & Associates.

He believes a client-centered perspective, backed up by robust professional certification, legislatively mandated green standards, increasing focus by tenants on the quality of the workplace environment, and a greater focus on what goes on inside the four walls will become commonplace.

"As offices and landlords attempt to reposition their assets to appeal to the workers and workplace of the future, technology displaces how buildings are sold, financed, leased, and managed, and the Internet of Everything redefines work, property managers will redefine their role to become more of a 'tenant experience manager,'" he says.

Where property managers were once most concerned with the physical functions of offices and multifamily residences, he says, their responsibilities are now seen by tenants as creating and maintaining an environment that's aligned with occupants' values.

"Building owners want their property managers to create a setting that people want to be in, rather than one they have to be in," Lee says. "So what is truly being managed is the whole experience of the building, not just the physical attributes of the property." In the future, Lee contends, "it would be more accurate to describe the property manager as an enterprise or business director."

Managers of vertically integrated funds, particularly of multifamily residential properties, say tenants are already creating momentum for that shift.

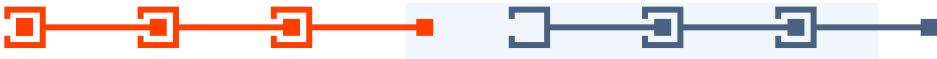
David Birnbaum, co-CEO of Griffis Residential, a Denver-based fund that owns and runs 8,000 units in Colorado, Texas, Nevada, Washington, and California, says the resident experience is a principal measure of performance.

"We employ a variety of tactics at the site level to ensure a positive resident experience," such as incorporating mobile technology and web portals to provide smooth communication with residents on everything from package deliveries to maintenance visits. Beyond the operational level, he says, Griffis Residential has also boosted its technology for its portfolio and financial management.

"I don't think we're moving toward apartment buildings that are like the Amazon stores without human cashiers," he says. "We're trying to use technology to enhance the connection between people, not replace it."

Chuck Leitner, CEO of the Berkshire Group, says his firm has an information technology steering committee to review and support changes on the operational and portfolio level. Real-time information management is now an expectation of residents of Berkshire's approximately 24,000 units, as well as of investors in its funds.

"I think we're seeing technology affecting both property and investment management," he says. "We continue to invest a great deal in it, and it's part of how we add value." ■



When Close-Ended RE Fund Managers Open Up

Open-ended real estate funds are popular with investors looking for liquidity, but they require a unique skill set from their close-ended peers

Open-ended real estate funds, where investors can claim redemptions on a quarterly basis, have technically been around since the 1970s. But the lack of reliable valuations and inconsistent performance left only a handful operated by major financial groups standing when the dust settled.

Then, approximately 10 years ago, they reappeared as investors clamored for more liquidity, only to collide with the global financial crisis. As the market recovered, so did investor appetite. And plenty of managers running close-ended funds had a newfound appreciation for their steady income. Better yet, they could tap their current expertise to launch them.

"The detail behind the acquisition of the underlying assets is the same, whether they're in a closed- or open-ended structure, with the same level of due diligence and [rigorous] underwriting process," says Christopher Merrill, CEO of Harrison Street Real Estate Capital, which manages six closed-ended funds, as well as the only open-end fund exclusively targeting demographic segments of education, healthcare, and storage.

Many firms found that their close-ended investors were hungry for them to launch an open-ended vehicle. "Investors are

looking for products that offer solid income as well as lower volatility," says Merrill. "With that in mind, an open-end fund in our asset classes could offer a differentiated product that did not exist in the market."

Open-ended funds tend to be more cyclical, so when paired with close-ended offerings, they can create attractive diversification. Some investors will participate in both varieties with the same team. But that team does need a different set of talents to manage open-ended funds well.

"In ways, it's more like running a publicly listed company," says Hugh Macdonnell, a managing director and head of client capital management at Clarion Partners, a firm with a rare 30 cumulative years' experience managing open-ended RE funds. He explains that the balance sheet issues and shareholder communication more closely resemble those of a publicly listed entity.

For example, valuations are generally conducted on a quarterly basis with the use of third-party valuation firms. "A standardized valuation process in the open-end fund industry has inspired confidence in valuations; this has been one of the key factors in the success of this generation of open-end fund vehicles," says Macdonnell. "It gives real integrity to the NAV."

However, Macdonnell notes that, unlike a public company, an open-ended fund's treasury is responsible for providing redemptions; they are not usually traded between investors. Before the close of a quarter, investors will request redemptions, and typically at the end of the following quarter the fund's treasury will pay those out.

There's also the matter of managing capital inflows on a quarterly basis. Some funds receive capital commitments quarterly, some even monthly. And investors can wait until the end of that quarter or period to formally commit that capital, making it hard to gauge a final tally. So long as their documentation is in order, many firms will take that commitment on the last day of the period.

As unpredictable as capital inflows can be, the firms we spoke with are rigorous in gauging how much capital to target. Some only take in capital once a year, some set a target every quarter, and some will put large amounts of capital in queues until they have opportunities to match it.

"Given our asset classes are smaller in nature and harder to access, it is important that we manage the amount of capital we raise so as not to alter our investment thesis," says Merrill. Naturally, capital outflows can be even trickier to manage.

"Open-end funds are constantly buying and selling assets, so while real estate is generally an illiquid asset class, there are consistent opportunities to refresh our treasury," says Macdonnell. In some cases, such as in the wake of the financial crisis, managers will put gates up on capital outflows to avoid selling off a portfolio at a loss.

"You do have to communicate with investors about the integrity of liquidity events," says Ryan Krauch, a principal at Mesa West Capital, which manages an open-ended mortgage debt vehicle in addition to close-ended funds. As a debt fund, Mesa West uses loan repayments to meet redemptions. Market participants stress that no investor wants managers timing sales to liquidity events. Instead, it's important for managers to explain how they'll avoid the practice.

As popular as open-ended funds may be currently, most firms continue to expand their close-ended vehicles in order to offer different varieties of liquidity and risk profiles. The real test of their popularity will be when the broader market slows down and gates go up on redemptions, since there's little difference between a closed fund and a "gated" one. ■

KKR REAL ESTATE:

Buying Complexity, Selling Simplicity

A keynote interview
with **Ralph Rosenberg**,
head of KKR's growing
real estate platform

How would you describe KKR Real Estate's investment philosophy?

Ralph Rosenberg, KKR: We started our real estate business about six and a half years ago. Our thesis was that we could leverage what was nearly 40 years of history of KKR at the time, with respect to the ability to harvest information within our own firm across all the different businesses—private equity, credit, infrastructure, energy, global macro, public affairs—to figure out really interesting ways to take real-estate-related risk.

About 80 percent of our investments to date have been thematically driven. The other 20 percent of our business is reacting to a market situation or a fact pattern that might not fit neatly within a theme that we're focused on, but where we can pivot and take advantage of an idiosyncratic, deal-specific opportunity.

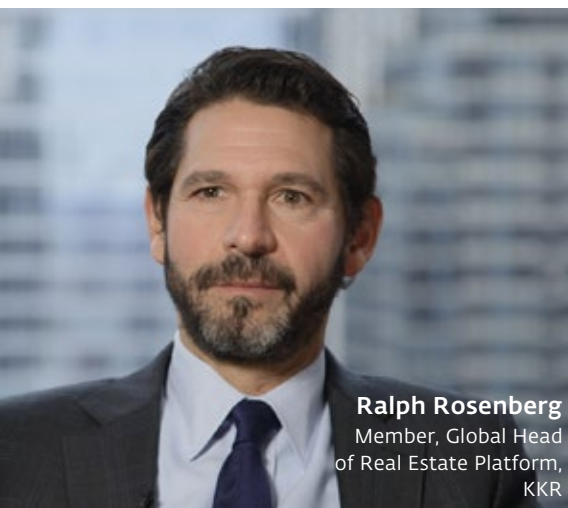
Given that we're likely nearer to the end of the cycle than the beginning, has your strategy changed?

Rosenberg: I believe that we are closer to the end of the U.S. economic cycle than at the beginning of the cycle. We don't need to really debate that.

And I also believe that if you're good at sourcing opportunities and identifying themes, you can transact no matter where you are in a cycle. Of course, you might have a different attitude in terms of what types of risk you're willing to take.

So, for example, we aren't interested in taking long-dated development risk, and we aren't

↓ CONTINUES ON NEXT PAGE



Ralph Rosenberg
Member, Global Head
of Real Estate Platform,
KKR

interested in taking real significant value/repositioning risk. So what does that mean we are prepared to do? We are focused on and are very prepared to take risk where there's a shorter-dated business plan that gets you from a complicated fact pattern to a simple execution. We're interested in buying assets with more recurring cash flow that can be reinvested into the assets to create attractive returns on that reinvestment capital. We're focused on finding opportunities where we have the ability to access the capital markets to create long-dated efficient capital structures from a leverage perspective.

Then, lastly, we have a bias towards transacting in what I would call the top 15 markets in the country.

In terms of geographic focus, how has the real estate practice evolved?

Rosenberg: We are set up to be value-add and opportunistic investors in the United States, Europe, and Asia, where we have teams that are transacting every day. I would expect that over the foreseeable future those strategies will continue to scale and create what we consider to be a dominant middle-market presence, with the benefit and the advantage of having our bulge-bracket firm create information flow, sourcing capabilities, and operational expertise.

You're also using that to create opportunities on the credit side of the equation as well, correct?

Rosenberg: Yes. Literally in two and a half years, we've gone from having no market-facing capability in the credit space to a major publicly traded commercial mortgage REIT, which is called KKR Real Estate Finance (KREF), that trades on the New York Stock Exchange. We lifted a team of debt professionals out of Rialto and integrated them into the KKR real estate franchise. The combination of having a debt platform and an equity platform is quite powerful and is part of our strategic vision, to face the marketplace, to be a solutions provider across the capital structure.

KKR likes to bill itself as a firm that "buys complexity and sells simplicity." What does that mean in practice?

Rosenberg: Most of our deals are those that aren't digestible by what I'd call a traditional market participant.

For example, we were presented, as was the market, with the opportunity to buy an office and retail building in Chicago called Sullivan Center, which was marketed as a 98 percent occupied office building. That should have attracted a lot of core or core-plus interest.

But when you dug in, there were a number of things that were quite complicated. Number one, there were historic tax credits owned by Sherwin-Williams, the paint company. The owner of the property had to make certain reps and warranties as the owner to make sure that Sherwin-Williams didn't trip their tax credits.

The second problem was that the seller was involved in a very litigious partnership dispute, which included one of the partners being indicted and going to jail for fraud associated with other activities. The third area of complexity was that the two major leases in the building expired within five years of

taking ownership, and so a lot of core and core-plus buyers were worried about re-leasing.

Lastly, the most complicated part of the deal was that one of those two major tenants was a subsidiary of the state of Illinois. The state was not paying its rent, because the Illinois legislature was in a budget dispute, and the tenant was eight months in arrears.

We saw all of these facts and thought, "This is a great asset, and if we can figure out a way to control it at the right price, we can solve all these problems." And so we went to Sherwin-Williams and we figured out a way to buy them out of their tax credits. Our public affairs team went through the governor's office to discuss the lease. We figured out a way to take clean ownership of the property in spite of the fact that the two selling partners were litigating with each other.

We deconstructed that series of complex facts and made each one of them quite simple. We've since sold the retail piece of the building.

When the cycle does come to an end, what do you expect in terms of peak-to-trough valuations?

Rosenberg: For the market broadly, I expect it to be modest, around 10 percent. But if you look at certain asset classes in certain markets, the correction could be really, really significant. Look at what's happening in the hospitality sector in New York. You had supply increase by 15 percent, and hotel owners couldn't push up rates. In fact, they've had to reduce rates to keep occupancy. Organized labor has a favorable contract, basically creating a cost structure in the asset class that is fixed and contractually growing every year, foreign tourism is down and you've got Airbnb.

You add all that up and for that market, the peak-to-trough could be 30 or 40 percent. ■



THE MILLENNIAL IMPACT ON REAL ESTATE

**How America's largest generation is changing
the property investment opportunity**

KEY FINDINGS

1. Millennials are transforming the urban real estate market
2. As they age, millennials are influencing suburban real estate as well
3. Millennial shopping habits are changing retail and logistics
4. Millennial work habits are reshaping the office landscape
5. Co-working office providers are becoming the biggest lessees

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Peter Ciganik
Managing Director,
GTIS Partners



Andrew Jacobs
Managing Director,
Metropolitan Real Estate



Michael Schwartz
Principal,
RSM US LLP

1. Millennials are transforming the urban real estate market.

Millennials are the largest generation the U.S. has ever seen. Numbering just over 83 million, they represent more than a quarter of the nation's population. And with their spending power, they're changing the way America does business.

They're having a significant impact on the real estate market. Unlike their parents, millennials enjoy life amid the hustle of urban hubs. They gravitate to downtown areas, where they tend to rent rather than buy. "Urban downtowns have revitalized in a number of gateway cities over the last decade," said Peter Ciganik, managing director at GTIS Partners. "Millennials have finished college and found their first jobs, and now they're able to set up their own households. Of course, those households will first be rentals. And these people are young. They enjoy the fun of the city."

For the past several years, millennials have flocked to the bright lights of "24-hour cities," and real estate investors have followed. Now, as rents in these places soar, millennials are migrating again—and investors are on their heels. For example, as San Francisco rents have ascended into nosebleed territory, priced-out millennials have shifted across the bay to Oakland and other "18-hour cities," with investors right behind, injecting capital into once-forlorn office, retail, and residential properties.

"In New York, we have a client that's investing in multifamily and residential in Queens right now," said Michael Schwartz, a principal at RSM US. "In the 18-hour cities, we're seeing an influx of people who don't want to live in the 24-hour cities because of price. They're moving to cities such as Columbus, Madison, Raleigh, and Nashville."

These next-tier cities are now the Goldilocks zone for investors: not too cold, not too hot. "Investors in search of yield need to go to these secondary cities, especially if you're a high-yield, high-return investor," said Andrew Jacobs, managing director at Metropolitan Real Estate. "San Franciscans and New Yorkers—young ones—are spending half their income or more on rent. They can't spend more. The wage inflation isn't there to support higher rents. So the peak, we absolutely see it."

2. As they age, millennials are influencing suburban real estate as well.

Millennials are growing up, of course, and as they do they're getting married, having kids, and moving out of downtown areas, primarily in search of better schools for their children. "Unfortunately, downtown public schools in a lot of places have been underfunded for years," Ciganik said. "And how many people can buy a condo in New York and then send their kids to a private school? Not that many. So moving to a place where schools are good and space is affordable becomes the choice."

Still, a lot of these suburban-bound millennials can't afford to buy a house, so they rent. Result: Single-family rentals are now the fastest-growing sector of the rental market. Eight million new rental units have been filled over the last five or so years, and 5 million out of those 8 million are single-family rental homes, not high-rise apartments.

Fannie Mae has recognized this trend. In January, the agency announced it would guarantee the billion-dollar rental-homes debt fund of Blackstone, the largest owner of rental homes in the country. Not surprisingly, other institutional investors are getting interested in the rental-home sector.

"There are about 15 million rental homes out there, but most are still owned by moms and pops," Ciganik

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said. “Only about 280,000 of these homes are owned by institutions, less than 2 percent. But it’s growing fast. It’s actually growing faster than the multi-family REITs back in the early 1990s.”

3. Millennial shopping habits are changing retail and logistics.

Millennials prefer to do their buying online—they make over half their purchases there. But they do still enjoy some real-world retail experiences, and retailers are evolving to accommodate them.

“There has been a barbell in terms of success,” Jacobs said. “There’s an experiential nature to retail, especially on the luxury end, and people still like that. We continue to see growth there. On the other end of the spectrum are the discounters. In most cases, discounters are able to undercut online, so we’ll continue to see demand for discounters. It’s the in-between that’s been really tough.”

Malls that don’t see as many shoppers as they used to are repositioning themselves to attract visitors with new offerings. They’re adding restaurants, cafés, and bars, because millennials love to mingle. And they’re adding medical offices, because “you still have to show up to your doctor’s appointment—for now,” Ciganik noted.

In many malls, onetime grocery stores have been taken over by health clubs like L.A. Fitness and XSport Fitness. “These malls were built at the intersection of Main and Main for so many years,” Schwartz said. “There may be a higher and better use than an enclosed mall, but it’s still great real estate.”

Meanwhile, space for logistics has benefited from the boom in online shopping. “What’s been bad for bricks-and-mortar retail has been good for logistics and industrial space,” Jacobs said. “Both large distribution centers and, particularly, closer-in distribution buildings have seen extraordinary growth in rents.”

4. Millennial work habits are reshaping the office landscape.

Millennials like open-plan, fully digital, creative office spaces. This opens opportunity for some property investors but presents challenges for owners of old-school office buildings. “We have a building where Goldman Sachs and Facebook are tenants,” Ciganik said. “What attracted them to the building is that it has high ceilings, it’s all glass, so there is a lot of light, and it has redundant fiber. It’s heavily connected.”

With white-shoe firms as well as TAMI tenants (technology, advertising, media, and information) moving to the open-plan connected office, the downtown office landscape is shifting. “In New York, traditionally the highest office rents have been in the Plaza district, Park Avenue from 42nd Street up to 59th Street,” Jacobs said. “Now we’re seeing higher rents not only below 42nd but below 34th Street, in what we call Park Avenue South. I would say the buildings are physically inferior, but the rents are higher.”

The first to move in were startups seeking affordability and raw spaces—“midblock, nasty buildings with loft spaces,” Jacobs said. Now many companies that employ millennials are looking for similar office space. “I heard a midtown landlord say recently, ‘We’ve got plenty of old crappy buildings in midtown,’” Ciganik added.

In Chicago, companies once wanted space with a view of Lake Michigan. Now they want to be near transportation. “Millennials want to be closer to the L, so the West Loop has really expanded,” Schwartz said. “And you’re also seeing a lot of residential development in the West Loop.”

These trends are impacting traditional office hubs. As leases expire, tenants that no longer need so much space are downsizing. Who needs law libraries and conference rooms nowadays? In

New York, tenants are leaving once-prestigious addresses to go downtown or to Hudson Yards. It all spells trouble for those 1960s and 1970s buildings in midtown that can’t simply rearrange their interiors due to architectural limitations. Those formerly expensive buildings, with their deep cores and low ceilings, are emptying. “And for investors who have purchased those assets at 3 percent, 4 percent cap rates in a rising-rate environment, that will be challenging,” Ciganik said.

5. Co-working office providers are becoming the biggest lessees.

Co-working providers are now a force to be reckoned with. WeWork, the \$17 billion startup, added hundreds of thousands of square feet worth of new Manhattan leases in 2016 and will soon be among Manhattan’s top 10 tenants.

This has spurred investment in office properties that appeal to co-working providers. But there are risks in entering long-term leases with startups like WeWork. Does their credit hold up for the term or more when the investor wants to sell the building? “The jury is still out on the concept,” Schwartz said. “To underwrite those properties now, a lot of our clients are taking a bit of a risk.”

“We just signed on WeWork as a tenant, and we were hesitant to do it for more than a part of the building,” said Ciganik. Although co-working providers have bolstered their reliability by branching out to sign deals with corporations that need overflow space, they are still particularly vulnerable to recession, because they rely on users who rent space on a daily basis.

“It’s a convergence of asset classes: office and hotel,” Ciganik said. “You would never think of them as having a common operating element. But you check into a hotel for a day to sleep, and you check into WeWork for a day to do your office work.” ■

How to Make the Back Office a Competitive Advantage

That's right—fund administration can take a real estate fund to the next level

The maturation of the alternative asset investment industry has propelled the growth of many related service providers, but few have grown as rapidly and with such significant impact as fund administration.

In the last decade, as general partnerships grappled with the regulatory and investor-driven changes to the marketplace, firms have had to meet more rigorous reporting requirements and demonstrate greater transparency—all while finding investments and structuring deals in a competitive business environment.

While these added responsibilities may be viewed as an onerous distraction from a firm's primary investment mission by some general partners, fund administration can be done to competitive, cost-saving advantage.

Many administrators have developed the capability to provide cybersecurity, investor onboarding, and enhanced compliance services to asset managers, elevating their role from back-office functions to being an integral part of a firm's competitive profile. The next level is the ability of the fund administrator to amass and then analyze a huge volume of data that can directly support the fund's most important activity—making good investments.

Michael Halloran, chief executive of fund administrator NES Financial, which has particular expertise in EB-5 and 1031 exchanges, explains: "When you look at private equity and particularly alternative assets today, you have a whole ecosystem of providers out in the marketplace. These are your traditional fund administrators, so back, middle, some front-office services. But in reality, they're like plumbing. Fund administration needs to become much more strategic."

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The Transition

The financial crisis of 2008 and the multibillion-dollar Bernie Madoff fraud scandal reinforced the need for outside administration, a trend supported by regulators and investors, says John Phinney, CEO and co-president of business intelligence firm Convergence.

"There was already something of a movement, and post-Madoff, most investors said to their managers, 'You need to use a third-party administrator—I am not gonna get burned.'" Convergence's own data suggests that 92 percent of U.S. hedge funds, for instance, now use third-party administrators.

The industry is rising to the challenge and expanding the administrative functions that managers can outsource. Technological innovation has helped this rapid expansion, according to Michael Wilson, chief financial officer of Chicago Pacific Founders, a private equity firm specializing in healthcare. When he started his career in the early 1990s, he recalls, his firm needed an outside consultant to provide an internal-rate-of-return function in its Excel spreadsheet program, and the calculations took an hour or more. Now, he says, off-the-shelf software does the same thing in less than a second.

"Fund administration needs to become much more strategic."

—Michael Halloran, NES Financial

As automation increases efficiency, though, the combination of new reporting obligations and market competition has piled more responsibilities on a fund CFO's plate. Halloran says fund operation now requires superior capacities for accessing and retaining capital while finding opportunities to deploy it. Administrators like Halloran are developing technologies that not only help with the basics—proper reporting and controls, etc.—but transform the back office into a source of strategic advantage.

"Imagine if you had that environment fully integrated, where you could take data from internal performance data on the fund to external data within the sector, maybe within a particular region, and be able to analyze all of that data in real time," Halloran says. "That's fundamentally different than anything that's delivered out in fund administration today. The best funds out there are going to be better, faster, and smarter than the other guy, because they're able to take data from disparate sources, pull it together, and turn it into actionable intelligence. The delivery mechanism for that is going to be the fund administrator."

Converging on Cost Controls

Beyond the potential competitive advantages as they relate to the investment process itself, cost controls are an increasingly significant factor in the advantages conferred by top-tier fund administration. As asset managers respond to investor pressures to keep costs down and rein in non-core, non-revenue-generating expenses on the operations side, administrators have expanded their services to provide workflow and expense-tracking options that improve transparency and reporting efficiency.

Halloran estimates the annual infrastructure costs of private equity general partnerships at \$35 billion a year, and investors are pressing for reductions. "Those costs have to go down, and the value has to become higher," he says. "They have to be able to do more with less." Halloran speaks from experience. His firm manages seven times the number of limited partners, and 3.5 times the number of funds per employee, that the leading industry players do, as ranked by AUA.

Phinney, at Convergence, sees expense management opportunities as a major factor in hiring administrators, particularly by managers with funds that are domiciled overseas or have sizable numbers of foreign investors.

"Every advisor will tell you they're not in the business of running infrastructure—they're in the business of investing," he says. "So if I am looking to expand my business, having an administrator who has a presence in an overseas location, that's record-keeping and compliance requirements I don't have [to do internally]."

New Rules, Same Goal

Wilson, at Chicago Pacific, welcomes the improved communication and closer relationships with limited partners now embraced by most alternative asset managers. Next-generation fund administration helps strengthen those relationships and position a manager for future success. And with administrators able to quickly and easily report detailed metrics like the total value per invested dollar and distributions per invested dollar, the investor side is better informed and more discerning today than in the pre-crash era.

"In old days, if you invested in one of the mega-funds, it was like putting your money in a black box that came out the other end," he recalls. "Some of them used to report [to their LPs] once a year. I don't know that you could get away with that right now."

Much as they can't get away with viewing fund administration as just another expense. ■

WHAT GPS SHOULD KNOW ABOUT CARRIED INTEREST AND WEALTH TRANSFER

Changes to tax and other regulations could affect how carried interest is treated; three experts explain the road ahead

Privcap: How complicated—and widespread—is gifting points of carried interest?

David Stein, Withersworldwide: People have been doing it for quite some time. From a tax-planning point of view, there are a number of technical rules that come into play, so it can be a bit complicated. But the structures themselves, at the end of the day, can be relatively simple in terms of implementation. In terms of why people do it, it's really about taking an asset that has high growth potential and the ability to be valued on a current basis at a relatively low number relative to where it might go in the future. And carried interest is a perfect example of that kind of asset.

Is gifted carried interest typically placed in a trust? And is there anything unique about the way this trust is set up that people contemplating this process need to understand?

Thomas Wright, RSM: A very favorite technique of estate planners is the use of a type of trust where we include some language in the document that makes it what we refer to as a grantor trust for income tax purposes. The significance of that is the donor—the senior generation who creates the trust—gets the pleasure, so to speak, of getting to pay the income tax on the income and gains reported by the trust that, absent the grantor trust provision, would otherwise be a tax-paying trust. Trusts are normally tax-paying animals, so they pay their own income tax.

But this grantor trust feature that we all like to use shifts the income tax burden

back to the donor and allows the donor to report all of the income and gains of the trust on their personal tax return—and therefore allows the trust to grow tax-free. The assets are growing tax-free because the senior generation, the grantor to the trust, is paying the tax liability.

Stein: The grantor trust status also affords one other benefit, which is that a fund principal looking to transfer assets into a trust—if they have a more significant current value—may be able to do the transfer through a combination of a gift and an installment sale. And the installment sale to that trust from an income tax point of view would not be a recognition event, because the trust is essentially ignored for income tax purposes. So the carry can be moved into the trust even if it's at a level above what the principal can gift tax-free through a sale mechanism.

And then that current value will be paid back over time on an installment note. But the upside above the current value, plus a small interest factor, would be retained in the trust.

If a fund is wildly successful and the corresponding carry is substantial, would the grantor find him or herself paying all of the taxes on that carry, but receiving none of the benefit of those points of carry?

Stein: We have seen that actually happen in a couple of cases. The way that's typically addressed is there are a couple of different ways that grantor trust status is achieved in the first place. One of the ways is through a specific power that's given to

the grantor. And if the grantor relinquishes that power and if none of the other grantor trust attributes are present, then the trust would become a non-grantor trust and start having to pay its own taxes.

Let's talk about an important step that takes place at the outset of the gifting process, and that is assigning a valuation to the points of carry. Lindsay, can you walk us through that process?

Lindsay Hill, RSM: There's a lot involved in the valuation process, and it's pretty complex. We all know that private equity funds, hedge funds, and the related carry are not like a manufacturing entity. We're not just projecting volume and sales prices.

We're dealing with a lot more uncertain inputs, market performance being one of them. And the best way that we capture that in a valuation setting is through simulation. So in the case of a private equity fund, we would be using Monte Carlo simulation to come up with the exit proceeds for each planned portfolio company or expected portfolio company.

And that's really where our task becomes labor-intensive, because we need to have extensive upfront discussions with the private equity principals or with their finance teams to develop the expectation for when the investments will be made.

David, let's say you had a client who is badgering you for a ballpark of what the value of carry in a brand new fund might be. What would you say?

Stein: After all the hedging and caveats and so forth, if I had to put a number or a range on the table, I would usually tell people our experience has been that the valuations will often come out expressed as a percentage of the fund size at some low single-digit percentage. So in a \$1 billion fund, the carry might be valued somewhere between \$10 million and \$40 million or something like that. And then each individual principal is only going to have a portion of that. ■

State of the Real Estate Secondaries Market

As the industry matures, expertise
is still the key to success

Real Estate Secondaries Are Growing Strong

The real estate secondaries market has grown tremendously in the last decade and is increasingly being used as a portfolio-customization tool. While RE secondaries still lag behind the more mature private equity market, they're quickly catching up.

It's Not Just About Distress

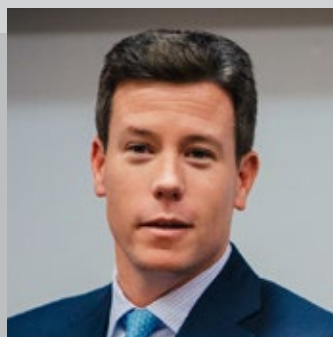
Over time, real estate secondaries are losing the stigma of a distressed play. Sellers are selling for a host of reasons, including portfolio rebalancing, general liquidity needs, and raising cash for a recurring investment in a GP's next fund. Buyers can be looking for a good deal, but also to increase exposure to a fund they already have a stake in.

It Takes a Lot of Expertise to Do It Right

The biggest challenge in secondaries? Valuation. Net asset value is a historic snapshot, so buyers and sellers need to do deep diligence to understand the ultimate value and prospect for future returns.



Philip Barker
Senior Managing Director,
CBRE



James Sunday
Partner,
Landmark Partners

The Globalization of Real Estate

An executive summary of the Privcap thought-leadership series on the opportunities and challenges created by increasing global capital flows

Key Takeaways

1. U.S. real estate is attracting strong interest from international investors
2. The profile of the global real estate investor is changing
3. Fund managers who take foreign investment face a series of challenges
4. The outlook for global investment is positive
5. The regulatory climate should continue unchanged

1.

U.S. real estate is attracting strong interest from international investors.

Investors around the world are searching intensively for yield, and this is driving interest in real estate, U.S. real estate in particular. International investors see the U.S. as, if not a safe haven, certainly a very desirable place to put capital.

In the U.S., “there is strong rule of law, a relatively stable government—despite what’s going on these days—and strong growth prospects,” said Peter Merrigan, CEO of Taurus Investment Holdings. “So people all over the world are interested in investing here, on a comparative basis, rather than in other alternatives.”

They see the U.S. as an efficient, risk-adjusted, return-friendly place to put their money. “Foreign capital went from something like \$46 billion in 2014 to about \$90 billion in 2015, down a little bit in '16, but the numbers have been very, very strong,” said Sean Bannon, managing director of Zurich Alternative Asset Management.

Other factors influencing the appeal of the U.S. market include the recession of 2008, when a lot of investors were badly hurt in emerging markets, as well as the uncertainty in Europe surrounding the future of the euro.

And, perhaps surprisingly, tightening regulation of the real estate market has not dented interest among global investors. “Irrespective of anticipated tax reform and other potential concerns, we’re still seeing just as much activity,” said Aureon Herron-Hinds, senior manager at RSM. “From a regulatory perspective, there have been increases, and there’s an anticipation that there is more reform on the horizon, but I haven’t seen the impact in terms of what clients are [interested in] doing. It’s still onward and upward.”

2.

The profile of the global real estate investor is changing.

Changes in the world economy over the past 10 years have changed the profile of the typical international investor in U.S. real estate. As nations in Asia have emerged as financial tigers, investment from Asia has roared ahead.

“By far the largest net increase in terms of the share of foreign investment in the United States has been Asia—that’s Singapore, China, and a number of different countries,” Bannon said. “It’s now somewhere in the vicinity of 43 percent, up from probably 4 percent from around 2007. In terms of folks that have shrunk in their share, Australia is down from around 18 percent in '07 to about 1 percent now. And the Middle East has given up about 10 points.”

Foreign investors are also now better informed and more strategic, another factor increasing the draw of U.S. real estate. They think more about risks and returns and less about the cachet of any particular market.

Negative drivers are also attracting investment from markets abroad. Merrigan said that, at Taurus, he’s seen an uptick in money from the Gulf, where trouble of all types is on the rise. He’s also receiving more calls from South America.

“I wouldn’t necessarily call it flight capital,” he said, “but I would say that they’re seeing a lack of alternatives and instability at home. So they’re attracted to the stability and the yield available in the United States.”



Sean Bannon
Managing Director,
Zurich Alternative Asset Management



Aureon Herron-Hinds
Senior Manager,
RSM US LLP



Peter Merrigan
CEO,
Taurus Investment Holdings

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Bridging the Cultural Divide

Peter Merrigan

Taurus Investment Holdings

The culture gap is one of the biggest challenges faced by fund managers with a large pool of foreign capital.

When you have investors coming from many parts of the world, their cultural expectations are very different. These investors are accustomed to operating a certain way in their own country, which is likely quite different from the way they'll be operating in the U.S.

"That's something we spend a lot of time working through," said Merrigan. "For example, a German investor may look at the world differently than a Saudi Arabian investor or a Turkish investor. We do have to try to be cognizant of that if they're in the same projects together."

So how can a firm go about gaining the necessary cultural insights? "A lot of it is education and knowing your client, knowing your investor," Merrigan said. "We spend a lot of time really trying to understand what their strategy is and what they're trying to accomplish, and then putting them in the appropriate vehicles and investments relative to that."

"From a regulatory perspective, there have been increases, and there's an anticipation that there is more reform on the horizon. But I haven't seen the impact in terms of what clients are doing. It's still onward and upward."

—Aureon Herron-Hinds, RSM US LLP

3. Fund managers who take foreign investment face a series of challenges.

For fund managers, it's not simply a matter of throwing out the welcome mat to foreign investors. Funds that accept investment from foreign sources face an imposing thicket of regulations.

That means funds need to pause and think. "What's going to be required if I accept this investment? Am I going to have to disclose information about my underlying investors or controlling persons?" asked Herron-Hinds. "If I do make those disclosures, what will it mean for the fund and for the investor? Will there be a withholding component, and now is the U.S. government or another country going to have information about them that I don't necessarily want them to have?"

Herron-Hinds pointed to things like the Foreign Account Tax Compliance Act (FATCA), which requires funds to disclose certain information about their investors. "In some instances, funds will be required to withhold on certain types of U.S.-sourced income that's generated from those investments," she said.

It is not only the Foreign Account Tax Compliance Act that fund managers must consider, though FATCA should certainly be near the top of their list. Other major regulatory regimes include the OECD's Common Reporting Standard and U.S. nonresident alien reporting and withholding requirements set forth under Chapter 3 of the U.S. Internal Revenue Code.

"FATCA requires disclosure and reporting of information about certain investors to the U.S. government," Herron-Hinds said. "And it requires withholding on certain payments in the event that it's determined that the fund or the investor is not compliant with FATCA—meaning that they either have not entered into an agreement with the U.S. government to report information or the investor hasn't provided documentation to the fund to establish that they're compliant."

This could subject them to 30 percent tax on certain income derived from sources in the U.S. U.S.-sourced interest, for example, may generate a FATCA withholding component. "It is therefore important for funds to develop systems, policies, and procedures to manage risk associated with these requirements and to pay attention to new global reporting obligations," Herron-Hinds added. "We've seen increased enforcement of these requirements, higher penalties, and more exams by the U.S. government recently in this area."

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A Taxing Situation

Aureon Herron-Hinds
RSM US LLP

When it comes to tax reform, the only thing that's certain is uncertainty itself.

"As the U.S. administration unfolds its tax plan, we're anxiously awaiting something that we can really wrap our arms around," Herron-Hinds said. "But the reality is that there may be decreases in certain tax rates or changes with respect to the treatment and deductibility of interest, so funds and investors will need to consider what that means for them.

"I keep going back to reporting and withholding requirements," she said. "You could potentially have exposure for reporting in jurisdictions and for withholding on things that you weren't previously reporting or withhold on and don't have systems or processes in place yet to start doing so now."

The reality, she said, is that increased regulations will not keep foreign investors out of the U.S., but they will require that funds themselves be prepared to respond to and comply with a number of new requirements.

Deep Dive

Sean Bannon
Zurich Alternative Asset Management

There are several strategic reasons why real estate funds are looking to attract foreign capital. Foreign investors help diversify a firm's capital base, and they comprise a deep pool of resources from which to draw.

"Some of the foreign investors are remarkably large," Bannon said. "So I think, from an efficiency standpoint, from an execution standpoint, and from an opportunity standpoint, there are tremendous benefits to having that kind of capital at your disposal."

Another benefit, he said, is that foreign investors can help create a fund that not only has various sources of capital but also has subfunds that can tailor exposures to different types of opportunities and different markets at different times.

"Oftentimes, the risk profiles may be slightly different," he said. "So as you think about the opportunities in the United States, with its different property types, deal sizes, and markets, you can create optimal portfolios. You don't necessarily have to limit your portfolio construction to a certain balance sheet."

4. The outlook for global investment is positive.

The macro picture for the U.S. real estate market over the next 12 to 18 months remains positive in most sectors. "We're spending a lot of time investing in multifamily and industrial, which a lot of other people are doing as well, but there is still good demand and dynamics there," Merrigan said.

He outlined the decision-making process on the investor end this way. They'll start out looking at the opportunities at home, and if they're in a market where they're making money, the U.S. becomes less attractive—and vice versa.

"I don't think we're going to see a significant spike in interest rates in the U.S.," he added. "I think it's going to be stable in near term. But with that 2 percent or 2.5 percent Treasury rate, there are still positive investment dynamics for foreign capital. It's a good yield, relative to what they're seeing in Germany, for example, where you have negative interest rates."

Supply-and-demand fundamentals are also good. "Very, very good," Bannon said. "And on the capital side, it's difficult to look at the pricing today and take issue with it. There's no question it's expensive, but if you look at yield expectations from equity sources and what continues to look like very responsible debt being originated, we don't have the same kind of interest rate environment or underwriting standards that we had during the last cycle. You can draw a lot of comfort from that."

5. The regulatory climate should continue unchanged.

Given the turmoil in Washington and the resulting legislative stasis, rules regulating real estate investment should continue or even improve. Whatever unfolds over the next year, the government will certainly maintain its pro-business stance.

"I think it's certain there will be tax reform," Herron-Hinds said, "but there's still uncertainty as to what it will be. I think we all agree there is not much expectation that there will be a tremendous impact with respect to investors in the real estate market and funds themselves."

She added that, with increased investment from abroad, she does expect stronger enforcement of the existing regulations requiring the automatic exchange of information, but she doesn't think this will discourage foreign investors. "Eventually they'll provide the information" she said. ■

Why You Should Save Some Cash for U.K. Property Opportunities

The \$48 billion real estate investment manager talks about the U.K. property market landscape post-Brexit and why investors should embrace the secondaries market

Aviva Investors is taking some of its capital “off the table” in the U.K. as it prepares for the next wave of opportunities.

Alistair Dryer, senior portfolio manager at the \$48 billion real estate investment manager, says the insurance company had been underwriting a slowdown in U.K. property markets since the beginning of 2016 and that it was now an “attractive moment in time” to be holding some cash, “because we think there will be opportunities” in the foreseeable future.

The U.K. saw its currency fall to a 31-year low against the U.S. dollar at the start of October after British prime minister Theresa May said Britain would start negotiations to withdraw from the European Union at the end of March 2017 and indicated she would prioritize control over immigration and borders, rather than access to the European single market. There were more currency gyrations in January as May gave a speech about Brexit and charted a course toward a clean break, or “hard Brexit,” with the EU.

Dryer, who is part of Aviva’s global indirect real estate team investing in indirect and direct real estate as well as debt, says there is so much uncertainty surrounding the U.K.’s withdrawal from the European Union that tenants are holding off taking on more employees or leasing up new spaces, adding to Britain’s property market slowdown.

“People are spending a lot of time trying to guess what’s happening,” he says, “and so we have a bit of a lag in [occupancy] take-up. We thought the U.K. would start to slow down; we had that in our forecast.”

However, he still sees “real demand for income from investors,” but returns would need to be underwritten with little to no economic growth.

Aviva Investors is seeing rising demand for longer-lease assets, traditionally provided by supermarket leases but moving to

Alistair Dryer
Senior Portfolio Manager,
Aviva Investors



more alternative asset types such as leisure, Dryer says. “Pension schemes are looking at it from a fixed-income perspective.”

Another bright spot in the U.K. commercial real estate landscape is demand for the private rented sector, or multifamily, says Dryer. “That is now becoming much more mainstream for institutional investors, and there’s a supply-and-demand dynamic, so that there’s not enough new construction occurring in the residential market.”

One issue that Dryer is keenly focused on is liquidity—and the ability to trade in and out of funds in the secondaries market.

“I invest on a global basis, and the key issue for our clients is how I get our capital out,” Dryer says. “It’s very important to make sure you have good investments and good funds, but something that is really important is the ability for secondary trades. It’s easy to get in [to funds]; it’s not so easy to get out.”

Aviva Investors expects to complete about \$600 million of secondary market transfers in 2016, and Dryer says he’s comfortable buying a secondary position at a premium, not least when open-ended funds are experiencing entry queues.

“Why not pay a premium to get into a fund, because the opportunity cost is lost? It helps me with my returns for my client. I can’t understand why investors are not using the secondary market—it can be an advantage.” ■

How Real Estate GPs Can Handle Increasing SEC Scrutiny

The SEC is turning its attention to the real estate sector, looking at the reporting of investment-level and fund-level fees and expenses. Experts discuss what compliance and operational challenges are facing real estate GPs, what best practices are being adopted in the industry, and how LPs view the fee-reporting issue.

Why is it that the SEC and increasingly sophisticated institutional investors are so focused on fees and expenses?

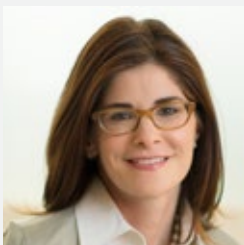
Lindsey Simon, Simon Compliance: What's interesting is that disclosure has changed in recent years so that LPAs [limited partner agreements] are now becoming more detailed in terms of what that disclosure is for fees and expenses. And a lot of these documents are supposed to be lived with for anywhere from seven to 10 years. The SEC, when they started registering private funds—especially real estate and private equity funds—in 2012, was not really understanding the difference in the type of disclosures. And so now that they understand private equity and real estate so well, I think that they're seeing a disconnect between what the documents are showing and then what the operations are and what is actually being charged.

Tom Green, RSM: The one thing that we've seen with these real estate structures is that they've gotten much larger and a lot more complex. So the opportunity for unintentional conflicts of interest to occur through related-party arrangements—whether it's asset-management fees or other fees at the joint venture level—has become heightened.

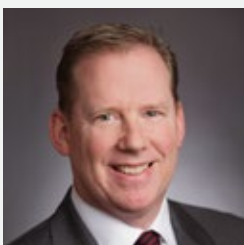
What evidence is there that the SEC is really taking this seriously or that very influential institutional investors are taking this seriously?

Simon: There have been three big cases [recently] that involve fees and expenses at private equity firms: Apollo, WL Ross, and First Reserve. Just looking at the SEC's enforcement actions or administrative proceedings is also a good place to see where the SEC is heading with this.

Lindsey and Tom, you have private equity and real estate fund clients. Are there any misperceptions among these managers about how they arrive at a sense of compliance and a clean bill of health?



Lindsey Simon
Founder & CEO,
Simon Compliance



Tom Green
Partner,
RSM US LLP

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Green: In general, one of the misperceptions is that if a fund is getting audited, that will include certain tests around fees and expenses confirming their accuracy. An audit is comprised of tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. It does not include tests or procedures for the purpose of expressing an opinion on individual balances or amounts. Therefore, while there certainly will be audit procedures around fees and expenses as they relate to related parties and/or they are shared or allocated across multiple entities, the audit itself will not confirm that the fees and expenses are totally correct.

Simon: When I ask my clients—mostly my new clients—if they've done any testing to review anywhere from 15 to 20 topics within the expense allocation bucket, they often tell me that their auditors have signed off because their audit was an unqualified opinion, which, as Tom has just said, is not the same. So performing forensic testing on a regular basis on your expense allocations and your fee calculations is something that auditors love for you to do. But it's not something that they are doing as part of their audit.

Green: The other thing that should not be assumed is, if you've been recording and/or reporting and disclosing fees and expenses the same for many years, that you have no issues. It's really important to have some type of test regimen that is done on some level of frequency to make sure that fees and expenses conform with the documents that are in place.

Many private equity firms are operating from funds that have documentation that was put together 10 years ago. What challenges does that present because the expectations from the SEC and from investors have changed?

Green: We can observe over time how fund documents such as PPMs and operating agreements and other related-party agreements in a fund structure have advanced. The entire fund formation and reporting process has changed. And the parties that are participating are a lot more focused, educated, and accountable. As a result, professionals such as compliance consultants, attorneys, and accountants have been able to elevate the document to be a little bit tighter around fees, expenses, and other conflict-of-interest issues.

Simon: Among the things that some of my PE clients across the country are starting to do are additional supplemental schedules that break down some of the fees, because their documents might be 10 years old. And someone who's a CFO knows which expenses are generally booked as fund expenses. Also, having the CFO involved in drafts of new fund-formation documents is important.

Lindsey, can you walk us through what a firm that does not have its ducks in a row might look like by way of fees and expenses?

Simon: You would maybe have vague offering documents. You would not have internal policies and procedure guides as to how you're going to allocate expenses. You wouldn't have a spreadsheet set up as to the different funds and their permissible calculation methodologies under the LPAs. You may or may not be calculating correctly, but then you also wouldn't be disclosing specific items—so, for example, in a financial-statement footnote having a related-party transaction footnote that has dollar amounts, or if you had a co-invest vehicle that received certain fees that you didn't offset.

There is a concept of fairness in allocation of expenses that is expected. What does that mean in practice?

Simon: There are some situations where you might have two funds investing in the same deal. It could be that you have another investment advisor that's investing—especially in real estate.

That brings up a whole other topic about real estate firms—private equity firms don't generally have this—having the word "reasonable" and "market rate" or "market comps" interspersed throughout their documents. And that puts an actual obligation on you to find out what the market rates are, especially if you have a vertically integrated firm or if you're doing salary reimbursements.

What are some common themes of firms where a lesson has been learned and where it's clear what the pattern of thinking was that led them down the path to eventually get into trouble with the SEC?

Simon: Traditionally, firms that have been around longer have more of a history of living with documents that are vague. It's important to have buy-in from the top. The principals of your firm should know how important this is. The initiative in California is pretty relevant in terms of the disclosure that's going to be required for California pension funds investing in alternative managers. That's going to change disclosures.

The mindset probably needs to change a little. I think there definitely has been a hesitation to disclose. The industry sort of is limping along to a little bit more disclosure. Hedge funds do a ton more disclosures. So it's just a matter of getting to that level, too.

Green: Especially if you're a newer fund or a startup fund, my advice would be to get in front of it at the very beginning, and surround yourself with good professionals and consultants and fund counsel, because it does become extremely complicated, and there's a lot at risk. There's reputational and personal risk. So it really is wise to make the investment in this compliance and reporting function. ■

The IRS Is Targeting Partnerships—Is Yours Next?

New audit rules have big implications for real estate investors

With the enactment of the Bipartisan Budget Act of 2015, the private capital industry should expect major changes to the way the IRS conducts taxpayer audits. Donald Susswein of RSM and noted tax attorney Fred Witt outline these changes and what they mean for managers of private funds.

Privcap: Why does the private funds industry now find itself in the crosshairs of the IRS?

Donald Susswein, RSM: There's a huge divide politically and culturally in this country related to issues of fairness or perceived fairness in our economy, with a particular emphasis on what people pay or should pay in taxes. Partnerships of all kinds have become the poster child for that conflict. Congress basically sent the IRS a message: "You better go audit some partnerships." That is coming. The new rules are going to take effect for any items of partnership income or deduction arising after the end of 2017. The enhanced audits probably won't begin until 2020, but the new rules begin to apply only a few months from now, and the IRS is really gearing up to go after partnerships.



Donald Susswein
Principal,
RSM US LLP

Fred Witt, Fred Witt PLC: In the last 10 years, there's been a sea change away from regular corporations and S corporations to the use of LLCs taxed as partnerships. The IRS and Congress perceive themselves to be a little bit behind the curve, and they are reacting to this dramatic shift in the marketplace.

Susswein: Fred, once the IRS does start auditing partnerships more, what are they likely to be focusing on?

Witt: Let's talk about LLCs taxed as partnerships. LLCs need to file Form 1065 annually. The first question will be: Who can sign the tax return? You might think, "Gosh, isn't that just assumed?" The answer for LLCs is no. For an LLC, the IRS tax return specifies that a "member manager" should sign the return. The term "member manager" is found nowhere else in the law. It's a creation of the IRS. This has important and critical consequences, because if the wrong person signs the return, it's the IRS' position that the return is invalid. If it's



Fred Witt
Certified Tax Law
Specialist,
Fred Witt PLC

invalid, the statute of limitations never begins. Every business owner and operator needs to drill down and check their documents to make sure that these matters are being addressed.

Susswein: I was recently having a conversation with an attorney representing another party. The attorney said, "Surely the IRS will recognize that this is just a foot fault. They're not going to hang a taxpayer out just for missing a technicality." I laughed, because that's the lifeblood of the IRS, right? If you violate a technical rule, that's one of the great ways they can get you!

Witt: Don, that's exactly right. The IRS has proposed these technical rules and has made the change for the first time in 30 years with the idea of increasing audit activity. They are going to want to collect whatever additional taxes are due. If they can do it based on a technicality, such as "The wrong person signed the return, and the statute of limitations never began," that, to the IRS, is a benefit. It makes it easier if they can get you on a technicality rather than trying to dive into the very complex, as they say, spiderweb of partnership tax.

Susswein: I've also heard there's a lot about fee waivers, carried interest, and profits interests in the private capital industry. Are those also areas that the IRS is going to be looking at?

Witt: They are. Carried interest has gotten a lot of discussion because of the legislative attempts to change the treatment of carried interest. As for fee waivers, the IRS and policymakers have a hard time having a lot of sympathy for a taxpayer who gives up \$1 million of ordinary fee income in exchange for \$1 million of somewhat speculative capital gains, even if there is some risk the gains won't arise.

Can you talk about the new partnership procedure rules intended to make it easier for the IRS to audit private partnerships?

Susswein: Let me try to give you a little bit of a summary: Partnerships file a single tax return,

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and the positions on that tax return are generally applicable to all of its partners in the partnership. They take their share of the partnership's income and put it on their individual return. However, a partner, if he or she wants to, can take a position that's inconsistent with the position of the rest of the partnership. That has been the law for many, many years. If the IRS wanted to audit the partnership, they would audit the partnership, but almost every partner in the partnership had the right to take an inconsistent position on his or her own personal return.

The IRS had to deal with potentially hundreds of different positions on the same tax issue. It was very, very complicated. It was one of the reasons why they generally avoided auditing partnerships. The big change that will be effective for 2018 is that henceforth the partnership is going to have to speak with one voice. The partnership is going to appoint somebody to have the authority to bind all of the partners in the partnership to a single tax position. This is a huge change. It's a simplification for the IRS.

What are some of the implications for a partnership when a single person can bind the whole group to tax positions?

Susswein: It means that somebody running the show, as far as the audit is concerned, may not have your best interests at heart as a partner. You might be a private equity fund, and you're holding a 40 percent interest or a 50 percent interest in a portfolio company, and somebody else may be controlling what that portfolio company does if they're audited, even though the impact of the adjustment may be on your fund as the investor.

Witt: The thrust of these rules is to treat the partnership like a corporation and take all of the power, all of the decision-making, and make the partnership like a corporation for purposes of auditing and determining additional taxes due. This means that the personal representative of the partnership has a very powerful position, and the person selected needs to be carefully identified and carefully monitored or controlled.

Susswein: There are circumstances in which a tax change that's proposed on an audit may affect the general partner in a way that's different from the rank-and-file investor. This is a potential morass of conflicts of interest. It doesn't mean they can't be resolved, but it means that unfortunately you can't just go to a lawyer or a CPA and say, "What's

the magic language I put in my agreement? What's the 'boilerplate' I can add to protect me?" It isn't a matter of magic language. There are real business issues, real conflicts, that need to be resolved as a business matter. For example, are certain decisions so simple that we can trust the manager to do it, or are all of the decisions on dealing with the IRS going to have to be put to a vote? If they're put to a vote, does everybody get the same type of vote?

Witt: I've spent the last two years in my practice drafting sample forms of the so-called boilerplate language that Don referenced. I think that section now has to be put into the trash can, because for the reason you just described, there isn't really going to be any boilerplate that will fit.

Susswein: All of this doesn't necessarily mean that there's going to be an elaborate redrafting of the partnership agreement. It may be a one-sentence addition. The difficult part is thinking it through. That's the hard part. In most cases, it may not even have to be in a partnership agreement, it may just be a side agreement, or it may just be a handshake or an understanding, but the point is, if you don't resolve these issues before 2018, they're going to be much more difficult to resolve later, if a real controversy develops.

Do you have clients who have said to you, "Gee, why don't we just wait until we get audited, and then we'll deal with this?"

Susswein: That is the normal reaction: "I don't want to do anything until the regs come out" or "I don't want to do anything until the technical corrections are resolved." But just think about your private equity fund and you're considering investing in a partnership. When you invest in that partnership, are you taking a risk for your own investors that maybe you haven't thought through? Maybe there's some claim that you were negligent in making an investment without your having made sure that that partnership had checked all the boxes, dotted all the *i*'s, and crossed all the *t*'s. And it's not as easy as just finding your tax advisor and asking them to do the work. He or she doesn't have an "easy button." There isn't any magic language or "simple button" they can press and all your problems are solved. It isn't an insurmountable problem, but it's a business problem that has to be worked through by the parties with a trusted advisor who understands the tax and business issues, not a problem of finding the right technical language to make the problem go away. ■

The CRE Cycle Returns to 'Normal'?

— As the Great Recession continues to fade, what will the future hold? Is commercial real estate set for a big fall?

Sonny Kalsi, a founder and partner of GreenOak Real Estate, a global real estate fund based in New York, says there's too much liquidity in the market for it to be distressed, but indicators from various sectors—such as an oversupply of high-end condominiums in New York, and falling prices for retail space—leave lots of room for improvement.

"I think the right word to use is dislocation, and that's been happening for some time," he says. "Cycles in real estate are generally driven by oversupply, and that's evident in different market segments."

Investors are generally hesitant, according to the brokerage HFF, which noted that there's about \$140 billion in committed but unfunded capital seeking U.S. real estate investments. Global deal activity for income-producing assets slowed 8 percent in the first six months of 2017 and 9 percent for the second quarter, compared to the same periods last year, according to Real Capital Analytics. Some markets fared far worse—the value of commercial real estate transactions in New York plunged 39 percent from the first half of 2017, according to the Real Estate Board of New York.

That's affected GreenOak as much as any fund, Kalsi says. "We have more dry powder now than we've ever had as a firm, and we've been a net seller." He sees an inflection point looming in pricing across most market segments. Kalsi won't hazard a guess on the timing, but notes that commercial real estate market dynamics can gain momentum—positive and negative—quickly.

"Investors have to understand they need to keep some chips on the table, because if a transaction opportunity arises, things can move quickly," he says. "That's especially true in a market like New York."

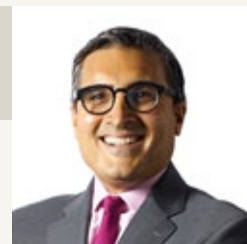
In the battered retail space, this part of the cycle represents opportunity for the right investors, says Scott Onufrey, president and managing partner of ALTO Real Estate Funds.

While headlines about department store closings and shopping mall occupancy rates declining reflect broad sentiments about the future of the retail industry, Onufrey points out that he and his investors are focused on the asset, rather than the occupying tenants.

"The fundamentals in commercial real estate remain strong—construction of new projects has been relatively

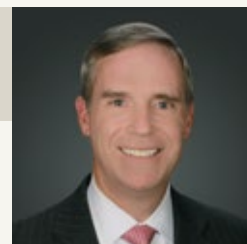
Sonny Kalsi

Founder & Partner,
GreenOak Real Estate



Scott Onufrey

President & Managing Partner,
ALTO Real Estate Funds



stable, there hasn't been a lot of excess leverage in the system, and there hasn't been a lot of frothiness in chasing deals," he says. "There's a pullback from top-of-the-cycle pricing, but it certainly is not a bubble."

And in ALTO's chosen niche—neighborhood and community shopping centers—the negative headlines have done no harm. Outside of premier markets like New York, San Francisco, or San Jose, those types of properties are getting better pricing as a result of the steady stream of dire headlines.

Buyers are seeing drops of 150 to 200 basis points, estimates Onufrey. Occupancy rates remain high, and lending has been stable. But some investors have stayed on the sidelines.

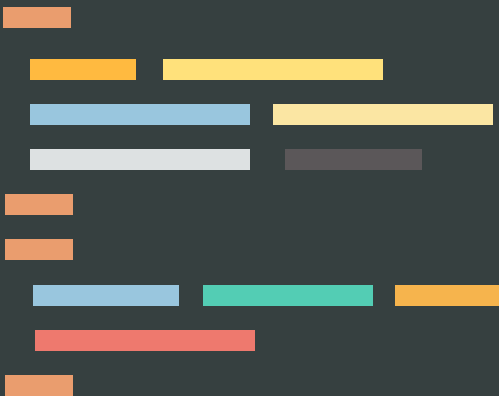
"When you visit with LPs, there are two camps," he says. "One is reading headlines and is very nervous about retailers, so we talk to them about the real estate itself. The other camp is real estate investors who understand that if you're buying high-quality real estate locations with diverse high-quality tenant mixes, right now these are actually bargains."

While commercial real estate has seen better times, the asset class has certainly fared worse, and now there's far less likelihood of an overnight collapse like the one cause by the 2008 crisis.

"Now we're back to good old-fashioned real estate cycles," Kalsi says. ■



Don't Be a 'Hacker Snack': Cybersecurity Done Right



True cybersecurity isn't about preventing every threat; it's about properly handling the inevitable

Cyber thieves have a name for a firm that mistakes prevention for comprehensive threat planning—a “hacker snack.” Hard on the outside, soft and gooey on the inside.

Unfortunately, too many firms are satisfying those illicit cravings.

The problem, says Daimon Geopfert, a principal at RSM US, is that many firms started from the perspective that if their systems got breached, they did something wrong. The reality, Geopfert says, is that no firm can prevent all attacks.

“This is a basic 80/20 problem. You can address 80 percent of your issues with 20 percent of your effort. Fixing that last 20 percent requires significant effort and expense and will never reach zero,” Geopfert says.

Well-managed firms spend lots of effort to detect and correct breaches once the inevitable happens. That requires a holistic approach that goes well beyond efforts to protect every point of entry. Not only will it eventually fail; it often costs more than necessary, Geopfert says.

Ultimately, the prevent-at-all-costs approach starts with the wrong question: How do I keep everyone out? Instead, Geopfert says, firms should first ask: What am I trying to protect?

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Know Your Data

The holistic cybersecurity approach is based on three core efforts: Protect, Detect, Correct.

Protection goes beyond the traditional concepts familiar to anyone with a laptop—firewalls, anti-virus, and keeping software up to date. Instead, it first requires understanding the types of data your firm handles and figuring out what requires the greatest level of protection. Real estate firms can deal with a broad range of constituents—investors, developers, operators, tenants—so the process can be particularly complex.

“You want to think in terms of ‘layers of trust,’” Geopfert says. He says the best example happens to come from the world of real estate—an office building. When you enter a building, there’s typically some form of security in the lobby, and then additional security protocols in place for sensitive areas like a data room.

Yet that isn’t how it often gets structured in the virtual world of data.

“It’s like once you get past the security desk, everything is in the lobby,” Geopfert says. The layering approach acknowledges that some data is more sensitive than others and therefore should be sectioned off from less critical information. And only those who need access should have it, and only the systems that need it can actually reach it.



Daimon Geopfert
Principal,
RSM US LLP

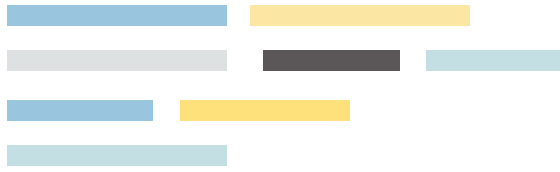
Know What’s Normal

Once you’ve prioritized and protected your data, you need to plan for the inevitable breach. Doing that requires pairing internal knowledge with software to define the normal and abnormal. Without that, there’s no way to identify suspicious behavior. Geopfert says that a Verizon study found that 87 percent of firms that experienced a breach had access to the information needed to detect it but were incapable of identifying it.

Luckily, he says, much of the most critical data is often relatively static, so it’s easiest to get a handle on it. Segmenting the critical data and systems away from day-to-day user systems and data, which is typically “noisy” but less critical, helps bring the real issues into clearer focus.

“There are some very binary use cases—if thing ‘X’ happens, it’s bad,” Geopfert says. “To get to the point where you can detect nuanced issues, such as changes in user behavior, there’s much more you have to do.”

Doing more involves using a combination of behavioral, trend, and heuristic information to define and trigger warnings. For instance, Geopfert says, picture a user who has never logged in before 7 a.m., never later than 7:30 p.m., has only touched five systems in the network, and only from three geographic locations. If that user logs in at 2:30 a.m. from a fourth location and proceeds to access other systems, then that should trigger an alarm. But a system can only be set up to “listen” for such events through careful study of existing patterns.



Know What to Do When Disaster Strikes

How a firm reacts when a breach occurs is as important as the steps meant to prevent and detect it. In fact, in combination with the layering approach detailed above, incident response is a key target of regulators, state attorneys general, and insurers—in other words, the groups that can make life after a breach particularly miserable.

The simplest advice, Geopfert says, is don’t go it alone. Internal teams should not be tasked with cleaning up an attack once it occurs. They should be technically capable of identifying a breach and then putting a response in motion—calling law enforcement, shutting down systems, alerting the public—but shouldn’t do the forensic work.

“Unless they’re a Fortune 50 company, they probably don’t have the budget to have that staff in-house,” he says. “Most organizations that try to do this themselves throw up their hands after a couple of weeks and call in an outside firm. There have been cases when insurers won’t pay fines because the firm didn’t properly handle the fallout, and while they were attempting to do the right thing, they actually extended the duration and damage of the event.”

The best real estate firms will put together a great plan, often with a consultant, and then run through it a few times a year. A practical approach works best.

“Don’t overthink it,” Geopfert says. “One of my clients has everyone on the team bring in news articles of breaches. They throw them on the table, go through them, and discuss how they would respond. It’s extremely effective.” ■