Russell Investments

Viewpoint

Russell Research

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The future of private real estate: Predictions for the next decade

This paper identifies ten potential trends and issues that could impact the shape of the industry between 2012 and 2022:

1. Secondary trading takes off on a global basis.
2. U.S. private real estate market will continue to dominate.
3. Longer term investors will include land as a core part of their real estate strategies.
4. Evolution of the buy, hold and sell private equity fund model.
5. An increased awareness of governance issues globally.
6. The presence of new 'rising industry stars'.
7. Core investment strategies will become a focus for investors.
8. The shift from defined benefit (DB) to defined contribution (DC) pensions (especially in the US) will present challenges and opportunities.
9. The globalisation of real estate will increasingly require an industry body at the global level.
10. ESG (Environmental, Social and Governance) issues will be top of the agenda for institutional investors.

How is the real estate industry going to change over the next ten years?

What will shape the industry over the longer term and beyond?

Introduction

How is the real estate industry going to change over the next ten years? What will shape the industry over the longer term and beyond? Although this is moving into crystal ball gazing territory to an extent, there are indeed a few good trends that are afoot in 2012 that have clear potential to impact the industry in the decade ahead. Other trends are pure speculation and possibly seared with hopefulness. That said, here are some boundaries for the thoughts presented over the following pages. First, the focus is on ten year trends - anything not expected to move the needle in that time frame has been discounted. Second, some changes are more localised and have a geographic focus. Some are global in nature. In either case, the geographic focus is identified. Third, the ten key trends are in no particular order.

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[1] Williams, D. (2012, July). "The future of private real estate: Predictions for the next decade". Understanding Private Real Estate by PEI. 10, 89-96. ISBN: 978-1-908783-11-0. Available at: http://www.peimedia.com/product.aspx?cid=&pid=271477.

1. Secondary trading takes off globally

In terms of investment in private real estate funds, primary transactions dominate over secondary transactions. According to Jones Lang LaSalle's (JLL) Global Secondary Market 2011 Round-up report, there were $5.5 billion in secondary trades in 2011, with 30 percent of that volume occurring in the UK.[2] Although there seems to be an upward trend of late, these figures suggest that secondary trading activity is not global and its market share as a proportion of the entire real estate market is negligible, measured in basis points rather than percentage points.

A few years ago, many pro-secondary groups cited the global financial crisis and overstretched real estate investors as an expected trigger to increase the volume of secondary trading activity. While certain specialist funds of funds have gained traction in capital raising, and there has been an uptick in secondary trades, the volume is still low and transparency is opaque. One market where transparency and liquidity has opened up is in the UK where there are many market players who regularly trade their UK fund exposure. However, secondary trades in the U.S., wider Europe and Asia are happening but are small scale in comparison to primary transactions. To put it into perspective, the opportunity fund currently being raised by Blackstone has closed on $10 billion of commitments, which is larger than the entire volume of secondary trades on a global basis in both 2010 and 2011.[3]

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In a ten-year time horizon, there is likely to be considerably more interest in secondary trading, with better price transparency. It is difficult to predict a trigger event that will make that happen, but over the longer term, the inbuilt demand from investors wanting to manage their exposures will mean that trading volume increases. Are there any obstacles to this happening? There are none that appear insurmountable or unmanageable. The right of first refusal (ROFR) process – where existing investors effectively have a chance to buy out the exiting investor – is one potential obstacle, but that does not apply to every fund and even when it does, it has proven to be a manageable process for the buyer, seller, general partner (GP) and limited partners (LPs) alike. In an era of increasing customisation of real estate portfolios and globalisation, I can only see secondary trading making a difference in the long term, which would ultimately benefit the entire industry.

2. U.S. remains the dominant market

There has been a lot of commentary on the rise of other real estate markets like China, Brazil and India, and of course there is a power shift in terms of the economic balance between the U.S. and other economies, which is opening up a realm of opportunities on a global basis. However, the country where the opportunity fund model started and which launched its first institutional real estate benchmark in 1982 (Frank Russell Company Property Index that is now called the NCREIF Property Index), and the geography that has the largest 'off-the-shelf' core funds in the world, is the U.S.. This argument is not founded on whether the U.S. economy will rebound and keep pace with other economies, nor is it based on the head start that the U.S. had in terms of real estate investment trusts (REITs) and investing in real estate on a fiduciary basis. Rather, it is based on a combination of the following traits that are likely to endure to the benefit of the U.S. market:

- An attuned focus on alignment of interest.
- A distinct hatred of conflicts of interest.
- A strong and diverse consulting industry.
- Large players that are domestic and global, core through to opportunistic.
- A willingness to question and re-engineer formats through which to invest in.
- Well-capitalised players in the market.
- Arguably, a market-leading academic basis in real estate investment and business generally that attracts some of the best and brightest from other countries, many of whom will set up shop in the U.S.
- Top-tier transparency.

[2] Jones Lang LaSalle. Global Secondary Market 2011 Round-up Report.

[3] Russell Investments. (February 24, 2011). Efinancialnews. JLL Corporate Finance.

To put it simply, most of the best practices in the real estate industry in ten years' time will likely have been invented, developed and honed in the U.S.

3. Land – a key strategy for long term investors

Many investors shy away from land as a strategy – little or no income, inherent risk in the zoning process, significant risk in terms of timing development – to name just a few reasons. Of course, these reasons are valid for many investors who are attracted to real estate for its lower risk, income and diversification characteristics. Those who take the longer term view and have balance sheets to match, however, have the ability to own land and potentially to produce intergenerational profits. We have seen this in terms of wealthy families or private individuals around the world, but this ultra long-term view has not pervaded into institutional real estate investment. This is not an argument for longer benchmarking periods nor a proposal to include land as a sector in benchmarks, but rather that investors with longer term horizons will start to appreciate the benefits of owning land through market cycles. It sounds a cliché but, after all, they are not making land anymore.

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4. Buy, hold, sell private equity fund model evolves

At the time of writing, a few noteworthy investors have challenged the wisdom of the private equity real estate fund model given their need to buy and hold real estate for the long term. Others view the model as cumbersome, given the market dynamics of the market crash and subsequent recapitalisation. Some complain of high fees and the J-curve effect. While all of these views might hold true to specific investors, a new format, or multiple new formats, will emerge from the industry. These have already started to happen with the explosion in co-investment 'sidecar' vehicles in the U.S., for example, but it is unlikely to stop there. It is not within the scope of this paper to outline how these future investment vehicles will look and function, but in ten years' time the investor on a global basis could be presented with an increased selection of investment options that sit alongside the traditional private equity real estate fund model. This is not to suggest that the commingled, private equity fund model will be phased out – quite the opposite. Rather there will simply be more options available than currently exist in 2012 for an investor to build on their commingled fund exposure, all at the same time as private equity real estate funds evolving in relation to term, investment period, fees, alignment and all the other items on an investor's wish list.

5. Good governance wins

There are huge governance issues in certain funds in particular countries. This section lists a selection of governance issues that can be found in many instances around the world:

- Advisory boards with discretion over investments (a few investors overriding the manager);
- A range of assumptions on expected unrealised performance;
- Many sponsors of core fund vehicles aggressively growing a competing separate account business without a coherent deal allocation policy, and
- Loose key person provisions that allow individuals unchecked time commitment to wider business interests.

With the globalisation of the real estate fund industry, there will be an increasing awareness of governance issues and, as a result, better aligned fund terms can be expected over a ten-year time horizon. Those fund sponsors who do not place alignment and fund governance at the top of their agenda will do so at their peril. The industry has been licking its wounds having experienced the perfect storm in 2008-2010, but the next decade will provide ample time for the key LPs and GPs to shape the fund model and, as a result, attract the accolades.

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6. Rising stars

In terms of the number of dominant players, emerging managers and their market share, little change can be foreseen in ten years' time. Rather, the significant change will be in the company names. Currently there are 75+ emerging real estate managers in the U.S. currently targeting U.S. distressed real estate opportunities. A handful of these will become dominant players through a combination of exceptional track records, market-leading alignment programs, strong endorsement from thought leaders in the LP community and an unending focus on attracting and retaining the brightest talent in the business. If all goes to plan, some of the first-time funds currently raising capital should be on their fourth or fifth fund in ten years' time. The next Blackstones and Starwoods are out there now and are in the early stages of making it big. There are also some up-and-coming small to mid-sized players that want to stay small to mid-sized, the best of which will have excellent brand recognition in ten years' time. Clearly, some well-known players now, some very large, will have significantly reduced presence through a combination of poor alignment, staff defections, under-performance and/or platform issues. Regulatory change might also impact some platforms, although it is perhaps too early to make that call.

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Frankly, there has not been a better time for a manager to emerge from the pack and to dominate in a specific way. There are also a number of well-known platforms that have drifted sideways and emerged unscathed from the turbulence of the 2008-2010 periods, but who now, with a certain amount of risk taking, could become dominant players on a global basis. There are also a handful of very large players that due to their truly global footprint, strong leadership and strong performance potential, are just as liable to be dominant in the long term. In summary, there are strong signs to suggest that there will be a new order in ten years' time, with a significant amount of joy and carnage as a result.

7. Focus on core investing

Many investors are attracted to the asset class as a result of the income stream and diversification benefits of real estate. Against that, many investors have significant non-core portfolios that comprise anything from residential non-performing loan strategies to full-scale development to traditional value-add strategies. Furthermore, some investors, for historically well-founded reasons, have invested the majority of their portfolio in higher risk non-core strategies, with a consequent lower exposure to core income-producing strategies.

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Any change to a focus on core investing was probably started in the aftermath of the recent real estate recession with investors appraising their risk appetite as a reaction to market events. At the same time, some argue that there have never been better opportunities to buy broken real estate, or broken structures that own real estate, and reposition them and ultimately to make a lot of money. This author believes they will be proved right but that most investor types will use core income-producing real estate strategies as the building blocks for their portfolio, even if they decide to align more with perceived higher risk strategies. In the bull period that ended in 2007/2008, some investors lost sight of the risks in their portfolios and that general risk aversion will now mean investors start with appraising the extent of their exposure to core and build out their portfolio from there.

8. DB to DC

The move from defined benefit (DB) to defined contribution (DC) pension plans has been well documented. In Australia, DB plans have almost entirely been superseded by DC plans. In the U.S., private sector plan sponsors are gradually closing their DB plans to new entrants or new accruals. It is a similar story in the UK. The consequent move from DB to DC is a profound shift in the way pensions are managed and implemented and it poses a challenge and opportunity to private real estate players.

Many real estate fund management platforms have been, and are currently founded on DB clients wanting their portfolio to be managed. The shift to DC will create different dynamics in terms of distribution of services and products, and ultimately different customers. It will also stress the importance of private real estate to state its case in terms of the benefits and weaknesses as an asset class. In plans where liquidity is at premium, the question might be how to accommodate the illiquidity of private real estate, yet still have a viably managed DC product. Those very same discussions that took place in the U.S. and Europe in the 1970s in terms of making real estate an institutional asset class and educating the asset allocators of the merits of the asset class, will all have to be revisited and more. Then, as now, there was an importance on transparency, information flow and speaking the same language as other asset classes. All of these will need to be deeply discussed in conversations, this time not only with asset allocators but multi-asset fund managers, strategists and ultimately the investors walking the street. Will it change the landscape in terms of the major players in real estate? Quite possibly, depending on their distribution channels and how adept they are at changing business models.

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It must also be said that private real estate is increasingly being referred to as a real asset alongside, among others, infrastructure, commodities and listed real estate securities. This might also present challenges to the asset class in terms of airtime with decision makers and ultimately a competition for capital. There are considerable opportunities too. Many individual investors have an affinity with real estate and a good base in terms of how the asset class, particularly residential, performs. Furthermore, the lack of liquidity in real estate can be appreciated and managed at the total portfolio level as long as there is some compensating attraction of the asset class. Looking to the Australian market, where real estate is popular in superannuation schemes, there seems to be a strong case that the U.S. and European real estate industries can take up these challenges and come through as a viable asset class. In ten years' time we may well see a new style of investing in real estate, be it in different formats or by different decision makers that have been effectively triggered by the move from DB to DC. The clock is ticking, albeit slowly, and the industry needs to wake up to these challenges in order to restate its case as an asset class.

9. A common industry voice

In terms of the way business is done in real estate funds, we are really talking more about private funds under private contracts as the norm. There are strict confidentiality rules and processes surrounding information flow within the manager/investor relationship but also in relation to any third parties. Unless the private commingled fund format evolves significantly, the manager/investor dynamic is unlikely to materially change. That said, the industry has learned a lot about the fund model during the distress of the global financial crisis. Simultaneous with that, the globalisation of real estate is still progressing, not at a great pace, but certainly a constant pace. Combining these two trends, it seems the industry needs an industry body at the global level. There are regional and country-focused bodies that are well founded – INREV (Association for Investors in Non-listed Real Estate funds) in Europe, PREA (Pension Real Estate Association) in the U.S., AREF (The Association of Real Estate Funds) in the UK – but the global perspective is invaluable and potentially lost through this regional focus (the existing industry bodies are partly a function of their membership wants and demands).

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A case in point is the emergence of fund models in Asia. Asia is high up the agenda for domestic players as well as offshore investors wanting to diversify their portfolio. The Asian fund industry is dynamic, exciting and young. In contrast, the US is a country where the opportunity fund model arguably started three decades ago, the last four years of which have proven to be a huge watershed period. There have been lessons learned the hard way in the U.S. and it now presents a variety of formats through which to invest client capital into real estate. Returning to Asia, there are new fund sponsors setting up shop that carry exceptional prospects in terms of strong teams, local knowledge and ultimately the ability to record strong risk-adjusted returns. But in many cases they lack the experience of best practices honed in places like the U.S. in terms of how to set up and run a fund for third-party investors. This may be arguing for more work for experienced placement agents, consultants and lawyers, but it is felt that an industry body with a global footprint

and with clear global goals could aid the industry in Asia. It works both ways too, there are some dynamic 'frontier' ideas coming out of Asia now and into the future, and some of that could have relevance to the U.S. (and Europe, Canada, Australia, Latin America and Africa too). A single global voice for the industry, or multiple voices each having a global remit, might aid the overall development of the asset class.

10. Environmental, social and corporate governance (ESG) issues

In terms of ESG and real estate, currently much of the emphasis is on the 'E' (environmental) element rather than on the social and corporate governance elements.

Based on research from Russell Investments, many U.S. and European core funds already take holistic approaches to ESG issues in that they are developing internal and external resources in ESG across disciplines (asset management, construction/ development, acquisitions, architecture and engineering).[4] Those very same fund managers are looking at payback periods (for ESG-associated costs and expenses) within the investment hold periods.

In ten years' time the potential exists for a sea change in the occupier demand for environmentally friendly real estate. Anecdotally, this has already started with larger, listed companies demanding better buildings, but this might move to include smaller companies. In addition, some business sectors are more attuned to environmentally friendly buildings – oil companies for example, or technology companies. This has the potential to spread. Furthermore, regulatory pressure may force the issue. After all, in countries like the US buildings contribute 39 percent of the nation's total carbon dioxide emissions.[5]

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As a result, in ten years' time, institutional investors are likely to have ESG issues at or near the top of their agenda combined with there being a premium attached to high performance buildings from an ESG perspective. In 2012, in contrast, there is not yet a discernible 'green premium' in terms of price or value. Future proofing a building is often cited as a goal of institutional real estate investors, both in terms of performance and sustainability. Should there be substantially increased occupier demand for green buildings, or regulatory changes, we are likely to see investors focused on the upside as well as the downside from being sustainability driven. After all, that is the right thing to do.

Conclusion

For what is one of the oldest and most traditional of asset classes in the world, the next ten years will undoubtedly see a substantial change to the way we do business in real estate. While many of the ten potential game changers listed here may not turn out exactly as described, the future top talent and leaders in real estate will have the wherewithal and flexibility to navigate through these trends, and more.

[4] Russell Investments. (April 2010). Themes on ESG current practice: U.S. and pan-European core real estate open-end fund managers.

[5] Environmental Protection Agency. Buildings and their impact on the environment, 2009.

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