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TalkingPoint

INVESTMENTS AND ACQUISITIONS IN THE REAL ESTATE SECTOR

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FW moderates a discussion on investments and acquisitions in the real estate sector between Chris M. Smith, a partner at Shearman & Sterling LLP, Iain Morpeth, a partner at Ropes & Gray, and Greg Williams, the national sector leader of asset management at KPMG LLP.

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FW: Could you provide a summary of recent investment and acquisition activity in the real estate sector over the last 12-18 months? Would you say market players are demonstrating confidence or caution?

Williams: Institutional confidence in real estate continues to grow. The volume of direct commercial real estate investment has steadily increased since 2009 and is rapidly approaching pre-global financial crisis levels. According to Jones Lang LaSalle, global direct commercial real estate investment transaction volumes hit a record high of $218bn in the fourth quarter of 2014, bringing the preliminary full-year volumes for 2014 to $700bn – a 28 percent increase over the third quarter, and an 18 percent rise over 2013; this growth is seen across the Americas, EMEA and Asia Pacific. As real estate moves from an 'alternative' investment to 'core' in an investment portfolio, sovereign wealth funds, pension funds, private equity firms and global insurance companies, among others, are increasing their stakes in real estate as both a hedge against inflation and a solid source of diversification and cash flow. As a result, demand for the best-performing assets in prime markets worldwide is increasing, with spillover to secondary and tertiary markets, and to non-trophy assets by investors looking for additional yield.

Smith: Caution is typically not the hallmark of developers, or more generally, investors in the real estate arena. Risk is an accepted element of the investment horizon and obtaining an appropriate reward for taking on risk is often the sought after goal. Such has been the case over the last 12 months or so. Investors are jumping in, prices are escalating in core markets at both a faster pace and to levels higher than anticipated, and yet there is no dearth of players. While today one often hears that pricing has become too aggressive and product – whether developed or sites to be developed – at reasonable pricing is the primary concern, assets continue to move – and briskly. The reward for taking risk is shrinking, yet the market appears to be immune to its impact.

Morpeth: I would say that market participants have displayed both confidence and caution. Writing a sizable equity cheque still requires confidence even though your underwriting criteria have been exhaustive. Return requirements drive the type of deal and the pricing but underwriting standards are high. Generally, activity has coalesced around two distinct transaction types: the opportunistic and the core/core plus trades. At the opportunistic end, there are still non-performing loan portfolio (NPL) transactions being transacted, many of them sizable. One recent example is the £4.5bn face value Northern Ireland NPL portfolio – Project Eagle – sold by NAMA late last year to Cerberus. On the continent there have been similar NPL and real estate owned or foreclosed (REO) portfolio sales conducted by banks. Spain and Portugal have progressed quite far down this road and interest is turning now to Italy. Sellers have been assisted by a recovery in asset prices, partly resulting from quantitative easing and partly from progression of the business cycle. We may soon see the beginning of the final clearout phase as banks dispose of the remainder of their NPL book to clear the decks. Commercial development projects, particularly if speculative, also command higher levels of return and there have been several examples of these transactions recently.

FW: What factors are driving today's real estate deals? Are any regional hotspots leading the way?

Morpeth: There are a number of different influences but there a couple that stand out. The first is the sheer availability of money looking to be invested in the real estate sector from around the globe. Capital is truly international in nature now. Another, which is perhaps unrecognised, is the ability to syndicate the equity in real estate projects in a tax neutral way. The application of the capital partner/ operating partner style of joint

venture to real estate has had a number of benefits. It brings the capital and the specialist expertise together and aligns their interests. It enables capital to feel more comfortable in going into new markets with a local partner. And it is no longer difficult to find investors for large real estate deals. Lot sizes over £250m gross can be acquired outright by a large investor, such as a sovereign wealth fund, or by a discretionary fund with co-investors or by a consortium of investors managed by an operating partner.

Smith: Lower expected return hurdles, availability of credit and cross-border infusion of capital, and an abundance of available liquidity, are all contributing to a robust US market. US Investors still speak of seeking 15 to 20 percent returns, however from our vantage point, they are constantly and quickly moving down the yield curve as they seek new investments, recognizing that in many cases there may have been a fundamental shift in the opportunity to earn such returns, such that to compete effectively investors often have to recognise lower potential returns that are attributable to long-term real estate investments. While not a universal truth – condominium development in New York City is an exception, for instance – it certainly is true in many asset classes. Cheap credit – both short and long term – prompt investors to both commit to projects knowing that a ready source of capital will be identified, and to accept lower projected cash-on-cash returns since they are able to increase their returns by borrowing at historically low interest rates, often locked in for long periods of time, thus goosing the return profile. Finally, foreign investment is constant, focused and committed to acquiring US properties both for return and as a place to park capital, notwithstanding the strength of the US dollar. Safety through preservation of capital seems to play a key role in a good many of these decisions.

Williams: With yields from fixed income products at historic lows, there have been high levels of capital and liquidity targeting real estate to generate returns. According to Preqin, as of April, real estate funds worldwide had $231bn of 'dry powder', or capital ready to deploy. At the same time, real estate investment trusts (REITs) are raising capital aggressively and institutional investors, including pension funds and sovereign wealth funds, are increasing allocations to real estate, which is contributing to cap rate compression and increasing sales prices. Investors looking for stability and security are targeting the top markets worldwide, including London, New York, Paris and Tokyo for investment. From a regional perspective, the Americas is the most attractive for investment, with JLL projecting a 15 percent growth in direct real estate investment in 2015, contributing to overall global growth of 5-10 percent.

FW: To what extent are investors targeting real estate assets in emerging and frontier markets?

Smith: Notwithstanding the relatively low returns sought in developed markets, emerging and frontier markets, while by no means abandoned, are not the primary focus of investors targeting real estate assets, particularly non-US investors who typically limit their endeavours to major US markets, such as San Francisco, Los Angeles, Chicago, New York, the District of Columbia and Boston.

Williams: Emerging markets are garnering interest from investors with long-term horizons who can be patient as these markets realise their potential. This is particularly true in markets such as India where regulations and structures are evolving to attract foreign capital for much-needed infrastructure and development projects. That said, emerging markets still represent a very small portion of most investors' portfolios as they look towards more developed countries in Western Europe and North America that have real estate investment opportunities at attractive price points and risk/reward levels, as well

as more established legal systems and general market stability.

Morpeth: There are specialist emerging markets funds and there are several private equity real estate funds that have regional allocations or their own specialist regional funds. Blackstone and Carlyle for example have Asian funds and some have allocations from their global funds investing into PRC and other countries in Asia and of course in India. Africa is gaining momentum as well. The majority of capital has not needed to take on the extent of the risk inherent in frontier markets such as Africa. There will of course be local regional funds and investors who invest in those markets but there is not momentum on this out of London yet.

FW: What major real estate deals have you seen in recent months? To what extent are these deals shaping the market or signalling future industry trends?

Williams: While insurance companies have historically been prolific real estate investors, the rise of investment from Chinese insurance companies is a significant trend in primary markets. In the US alone, Anbang Insurance Group's $1.95bn purchase of the Waldorf Astoria Hotel in New York was the largest price ever paid for a single hotel. This transaction was part of a wave of $15bn invested in US real estate in 2014 by Chinese insurers; JLL expects that figure to grow to $20bn in 2015. Further, in April 2015, China Life Insurance Group and Ping An Insurance Co, in partnership with Tishman Speyer, bought a majority stake in a $500m commercial real estate project in Boston. Beyond Chinese insurers, private equity real estate funds continue to be active investors. For instance, in April 2015, Blackstone announced a deal to purchase all outstanding shares in Excel Trust, and followed that up by agreeing to purchase a $5.3bn portfolio of commercial assets in the US and Europe, as well as $8.8bn in real estate loans from GE. Moving forward, we anticipate continued M&A activity due to the significant amount of capital earmarked for real estate investment that is ready to be deployed.

Morpeth: One recent deal we have been involved in is an example of one of the trends we are seeing. We advised a large opportunistic US fund 18 months ago on its acquisition of a portfolio of car showrooms out of an insolvent CMBS by way of a pre-pack administration sale at a time when sentiment was much less strong. The portfolio was let to the principal UK car distribution company and the value of the portfolio had gone down by over 40 percent from the time that the CMBS was originated in 2006. The opportunity was only available for a short time and it was not possible to organise senior debt in that time-frame. The due diligence strategy was executed and contracts agreed and exchanged within a couple of weeks. The fund took the financing risk and underwrote the whole deal with equity, and refinanced a few months later. This is a classic example of a distressed real estate opportunity and demonstrates that speed of execution and ability to underwrite completion is of the essence in getting these deals done.

Smith: The spreading of risk among players via joint ventures, capital markets – REITS in particular – sovereign wealth funds and long-term ground leases are signalling trends in the global marketplace. Although not a new trend, but certainly one that has become more prevalent, is the spreading of risk in investments by bringing in one or more co investors to shoulder some of the responsibility. This is true in both single-asset acquisition transactions, and portfolio plays. While this trend has several elements that contribute to it – identifying additional opportunities with major players, securing the opportunity to invest in larger and often M&A-type transactions, and possibly even confirming viability of investment analysis – the primary motivating factor seems to be to spread risk. The approach also allows existing owners to capitalise,

via recaps, on the high asset values of today without trading away all the upside or converting value to cash with few, or fewer, alternatives in which to reinvest those proceeds. The capital markets have, by and large, been kind to public REITS and as a consequence, many have become aggressive players in all asset classes, as have sovereign wealth funds. Both have been very active and have shown no signs of having filled their acquisition appetites. A disproportionate number of acquisition transactions are being financed in part via the creation of a long-term ground lease. This not only permits entities to procure a source of funding for a significant portion of the purchase price, but also serves as a 'ready home' for 1031 like kind exchange capital, which appears to be prepared to take a lower but reasonable semi-fixed return on the dollars they are not contributing to the coffers of the US Treasury.

FW: Are there any unique issues that real estate investors need to consider when negotiating and structuring an asset purchase? Are any particular areas often overlooked or underestimated?

Smith: What might be overlooked is examining the broader 'prospects' for a property, product type, city or industry. Hotels in New York City, with a significant number of rooms coming on line, and the resultant drop in RevPAR, seem to highlight a product type. Investment in Houston, indeed maybe all of Texas given current oil prices, may represent a city or state, hard goods retail, an industry. Whether parties are considering these factors is difficult to evaluate, however en masse I would say these factors are to some extent being ignored or more often 'explained' so that continued investment in or lending to the asset class, city or type is justified. I am not implying that opportunistic investments in these sectors do not exist or should be ignored, but rather that as an asset class or investment mode, they could be examined in much finer detail.

Williams: Investors should focus on the regulatory and tax issues that arise when structuring both domestic and cross-border deals. These issues can be extraordinarily complex and they need to be addressed proactively and holistically. In addition, investors often overlook how the structure will impact the ultimate exit of an investment. Careful consideration of the impact of the structure throughout the hold period and subsequent exit of the investment may have a significant impact down the road.

Morpeth: International transactions by their nature raise more issues than domestic ones because investors cross into another tax regime and another legal jurisdiction. Tax is the most immediate issue. An investor looking at another jurisdiction will want to ensure that it does not pay more in tax than it would have done had it invested in its own jurisdiction. Who it pays tax to does not usually matter. If there is an incremental tax charge of doing so then the tax cost will have to be modelled into the price. Broadly, it has been possible historically to tax plan with a high degree of certainty in the UK and Europe. This is now up in the air with the general antipathy to tax planning and initiatives such as the OECD looking at the location of profits , the UK diverted profits tax, changes to UK SDLT rules, transfer pricing and the introduction of general anti-avoidance rules.

FW: How would you describe bank lending and general financing for real estate deals? Is there easy access to credit in today's market?

Morpeth: One standout feature of the market over the last 12 months has been the return of the banks and financial institutions to the senior debt market. Morgan Stanley, Nomura, Citibank, SocGen, Depfa, Goldmans are all in the market. And underwriting criteria have been improving for borrowers. LTVs for senior debt have gone up from 65 percent to 70 percent already and margins have come down from the eye watering levels they were

in the period before the banks rediscovered real estate finance. Credit funds continue to be in the lending market, particularly at the mezzanine level. There is no shortage of capital at the moment for transactions at every level of the capital stack and at every level of return. Sponsors probably have a greater problem in sourcing transactions than they do finding the capital.

Williams: In North America, bank lending standards continue to ease with current lending near pre-global crisis levels. Increased bank lending may be needed to fill the potential gap due to impending maturities in the commercial mortgage-backed securities (CMBS) market; securities valued at $303bn are expected to mature in the US from 2015 through 2017 – a significant increase over the $117bn that matured between 2012 and 2014. In Asia, lenders are approaching allocation limits on real estate lending, which is leading to an overall evolution of lending, including hedge funds in Asia becoming active lenders in meeting the increasing demand for real estate financing. In many markets, we're seeing capital and REIT markets play an even bigger role and crowdfunding is on the rise worldwide. Overall, the debt markets continue to improve and there is sufficient debt for those borrowers with demonstrated track records and projects that are well underwritten.

Smith: The best analogy for the current bank lending and financing landscape is that we are into the seventh inning of the game, however, the end of the game is more likely to resemble a plateau rather than a cliff. The existing lending environment is reminiscent of 2006 – interest rates continue to compress and cap rates continue to fall. This is largely due to the impact of ultra-low interest rates and the appetite of international investors for real estate assets. While there is liquidity in the market, it is unclear whether current values are sustainable, particularly because they are starting to exceed replacement cost, which causes the 'V' in LTV to become less predictable. Also, cheap high-leverage financing may encourage speculation by real estate investors. SPE 'guarantor entities' are starting to make a comeback, which calls into question whether nonrecourse carve outs are being backstopped appropriately. Office building rents have been falling in the secondary markets, suggesting that values should also be falling rather than rising in those markets. There are high levels of liquidity currently, which means that takeout risk is currently quite low for lenders, but liquidity can dissolve very quickly. The quality of sponsorship is becoming more and more important to lenders as the market has become frothy and LTVs less reliable. Overall, non-bank lenders are taking a larger percentage of loan originations, as bank lenders grapple with an increasingly burdensome regulatory landscape – particularly the Basel III regulatory capital requirements – and insurance companies cope with the ever-tighter spreads demanded by the market. Most markets remain construction constrained – with some notable exceptions – which suggests that overbuilding is not taking place broadly as of yet and bodes well for a soft landing during the next downturn.

FW: Managing risk and identifying value are fundamental parts of the acquisition and investment process. In your experience, is enough due diligence being conducted in today's real estate deals?

Williams: Comprehensive due diligence of various types, including commercial, financial and legal, has always been core to real estate transactions. We are seeing an increased focus on due diligence as both deal costs and cost of failure escalate. In addition to the traditional construction and operating risks, there are new risks to address, such as cyber security, where the need to prepare for and address ever-evolving threats from all contact points has quickly ascended to the top of management's agenda, requiring a sophisticated understanding of vulnerabilities and mitigation strategies.

Smith: Traditional due diligence is not being short-changed today, despite the accelerating pace with which transactions are being committed to and closed. Both investors and lenders continue to stay focused on the fundamentals of the properties and matters specifically related to it.

Morpeth: Our experience is that the underwriting quality has never been higher. A full due diligence exercise is invariably carried out and since so many asset acquisitions involve acquiring indirectly, and so inheriting tax risk and other liabilities in the vehicle that is bought, a corporate, financial and tax review of the vehicle itself is also required. Capital providers can take different attitudes to risk and therefore to the due diligence exercise. Core investors tend to be institutional in nature and will tend to take a more intolerant view of issues that come up in the due diligence. A PERE or PE fund on the other hand is in the business of taking risk and so will want to know what the risk is but will also be looking for a solution.

FW: What are the prospects for investment activity in the real estate sector throughout the remainder of 2015, and beyond?

Smith: The second half of 2015 looks very strong in terms of capital investment, continuing for a number of reasons, at a minimum in prime cities and to some extent, the secondary markets as well. Residential is hot as a pistol and shows no sign of slowing down, while for sale residential is all the rage and healthcare remains prime. Longer term, we are hearing discussion of whether this price escalation can continue without a fundamentally stronger US economy, whether we have peaked or whether the downturn is around the corner. While this has to be a concern – what goes up must come down – if the US economy can build some strength, together with the influx of foreign capital and availability of credit, it could support quite a long and potentially broader rally. Leaving aside unforeseen world events, the one showstopper on the horizon is higher interest rates. The uptick in rates has already made a number of transactions uneconomic and a meaningful spike could put a very quick end to the enthusiasm predominant in the marketplace.

Morpeth: The year has started well but slowed a little in March and April in London, perhaps as a consequence of the UK election. However, we have a good pipeline of work both domestically and in Europe and are looking forward to these transactions flowing through during the remainder of the year.

Williams: A variety of underlying trends, including urbanisation, demographic shifts, infrastructure, technological change, sustainability and more, will cause dramatic shifts in the use of real estate assets worldwide. As a result of these changes, and real estate's growing status as a global asset class, we expect investment to continue to grow. In addition, private, public and governmental entities continue to amass capital to invest in real estate with the goal of generating above-average, risk-adjusted returns. Finally, the rise in interest rates – whether in 2015, 2016 or beyond – will certainly have implications in the marketplace, but we do not anticipate an overall change in real estate's positive momentum in the near term. ■