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RETURNS OUTLOOK FOR US REAL ESTATE FUNDS[1]

Deleveraging continues in the US real estate market, providing an ongoing deal flow for opportunistic investment strategies by asset managers able to discern and capture value at the asset level.

Much of the deleveraging is via the necessary replacement of securitised debt in the form of commercial mortgage-backed securities (CMBS), with public and private equity. From 2000 to 2007, US$941 billion of CMBS was issued in the US market to finance activities in US commercial property including the multi-family apartment sector. When the global financial crisis (GFC) hit, CMBS issuance declined to virtually zero and has only partially recovered, with around US$123 billion of new CMBS being issued since 2008. Significant pre-GFC CMBS will mature in the next couple of years and, despite a recovery in the CMBS market, over the next four years the difference between CMBS maturities and new CMBS issuance is expected to result in a deficit

of up to US$500 billion. This shortfall must be funded in other markets, and creates much of the current opportunity to acquire assets at attractive levels.

Apart from the looming CMBS recapitalisation shortfall, CMBS delinquencies will also require resolution via the sale of non-performing loans or assets. According to the Commercial Real Estate Finance Council, there are currently 3,294 individual CMBS loans with a face value of US$67.3 billion in delinquency and in the hands of financial restructuring and workout advisers.

The equity required for these recapitalisations will predominantly be either public equity or private equity, which have different drivers and goals.

Public equity comes in the form of publicly listed and traded real estate investment trusts (REITs) which, in the current US low interest rate environment, have tremendous support and dry powder capital from yield-seeking investors. REITs stand ready to competitively acquire well-leased properties with stable and predictable cash flows; assets that require only passive management.

Private equity comes in the form of closed-end funds (private equity real estate funds), often structured as limited partnerships, with capital commitments provided by total return focused defined benefit pension funds, endowments, foundations and family office investors. These funds opportunistically target the sector's non-performing assets, which may include loans, with a view to rectifying whatever problems exist at the time of purchase, including capital structure defects, physical defects, low occupancy and rents, and high operating expenses. Recapitalisation, rehabilitation and releasing programs are then executed to rectify the problems at purchase and create a stabilised, well-leased asset. These assets are then made available for competitive sale to passive, yield-seeking buyers, including the REIT sector.

These investments thus require active — sometimes 'heavy lifting' — management, across many areas, and require specialist teams to execute these strategies. Funds that have these teams and skill sets in-house are known as 'operators', and those funds that need to outsource active management functions are known as 'capital allocators'. Often capital allocators will partner with an independent operator in a local market, which will execute the active management strategies. However, this can lead to communication disconnects and some duplication of expenses and performance fees.

Most private equity real estate funds seek to generate internal rates of returns (IRRs) in the 15–18 per cent range, pre tax, after fees and expenses. However, individual assets acquired opportunistically in 2009 and 2010, which have now been sold after stabilisation, have generated IRRs above 50 per cent and equity multiples of above 2.5X.

OUTLOOK FOR SECOND-TIER CITIES

While the US commercial property market has recovered significantly, and these types of returns are no longer attainable, this is mainly the case in gateway cities like New York, San Francisco and Los Angeles, where some prices are back to or above pre-GFC highs. Second-tier cities, such as Dallas, Houston and Denver, still provide strong deal flow of assets that are available at significant discounts to replacement cost. For example, office buildings can be acquired for the equivalent of US$1,000 per square metre, and multi-family apartment communities (500+ apartments on one title) for US$500 per square metre. Many of these markets are seeing strong economic growth and thus office and residential leasing demand as a result of the unprecedented growth in the US energy sector, particularly shale oil and gas.

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Deleveraging in this sector is a slow process; the savings and loan crisis of the 1980s and 1990s took almost a decade to resolve. There are still many of hundreds of billions of US commercial property loans either in delinquency and yet to be resolved, or held in CMBS structures approaching maturity.

Potentially, these factors could generate opportunistic returns for some years to come which, for Australians, may be enhanced by any reversion to the mean by the Australian dollar. Likely favourable changes to US tax law for foreign investors in US real estate, as recently announced by President Obama, will also make the sector easier to navigate for non-US investors. ■

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