PREQIN SPECIAL REPORT: REAL ESTATE FUND MANAGER OUTLOOK

H1 2018

FOREWORD

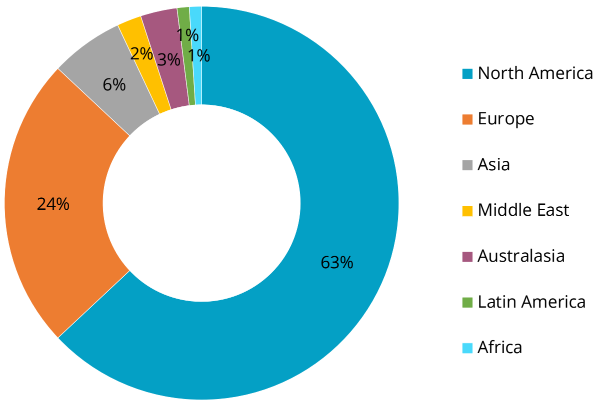
For firms utilizing a real estate investment strategy, it is a particularly challenging time. The concerns highlighted in our **H2 2017 Fund Manager Outlook** – namely pricing and competition for assets and investor capital – have intensified; now among these difficulties is the changing macroeconomic environment, with rising interest rates further complicating the operation of a real estate portfolio.

For firms raising capital, the market is very competitive, and it is obvious from the discrepancy between the numbers of funds closing and those being marketed that not all will achieve their goals. We are already seeing firms adapting their offerings in response to market conditions, either by taking on more risk, by expanding their strategy or, for 61% of firms surveyed that are bringing a fund to market, by reducing the targeted returns of these vehicles.

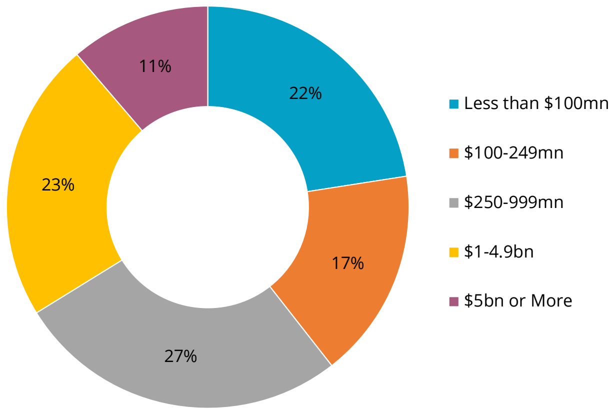
Despite such an environment, strong investor appetite prevails, backed up by a fund manager base that has generally delivered for investors in recent years. Distributions have been high, and target allocations need to be met. In a low interest rate environment, real estate continues to satisfy the desire for diversification, reliable income streams and attractive absolute returns. Fund managers able to express a unique value proposition and mitigate investors' pricing concerns will likely be the recipients of capital commitments in 2018.

For this report, we surveyed 215 real estate firms to try and understand how these issues have evolved, and how robust they feel the real estate market is when it comes to withstanding these challenges. We hope you find this report useful, and welcome any feedback you may have. For more information about Preqin's online platform, please visit www.preqin.com or contact info@preqin.com.

Survey Respondents by Headquarters Location:



Survey Respondents by Assets under Management:



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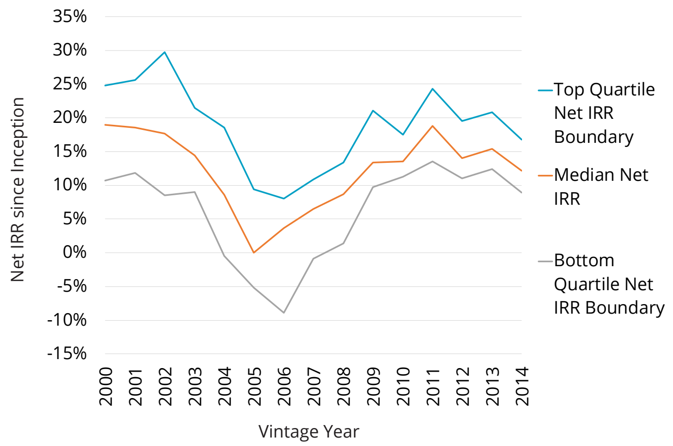
MARKET OVERVIEW

Real estate has seen many years of strong performance, with post-crisis vintages achieving consistent median returns at approximately 15% (Fig. 1). This has allowed fund managers to distribute capital back to investors at an unprecedented rate: since 2013 – the first year in which capital distributed exceeded capital called – nearly $900bn has been returned from closed-end private real estate fund managers to investors (Fig. 2).

This has been the driving force behind the positive perception of the asset class in recent years and has helped the fundraising efforts of real estate firms, with capital raised surpassing $100bn annually for the last five consecutive years (Fig. 3). This in turn has fuelled a largely consistent year-on-year increase in assets under management (AUM) of the industry (Fig. 4).

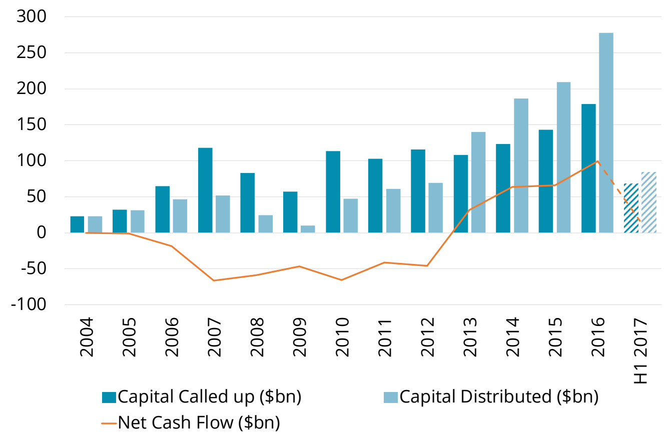
However, examining the market in more detail shows that the landscape is beginning to change. Firstly, fundraising – while strong – is centred around commitments to some of the largest fund managers in the space, which has made fundraising intensely competitive for the remainder. Secondly, capital available to fund managers is close to record levels, which has helped fuel the rising valuations of assets and the growth in the unrealized value of portfolio assets. Lastly, the success of the asset class and the corresponding increase in investor appetite has brought more managers to the fore than ever before, which is increasing the level of competition for available assets and affecting valuations.

Fig. 1: Closed-End Private Real Estate Funds: Median Net IRRs and Quartile Boundaries by Vintage Year (As at June 2017)



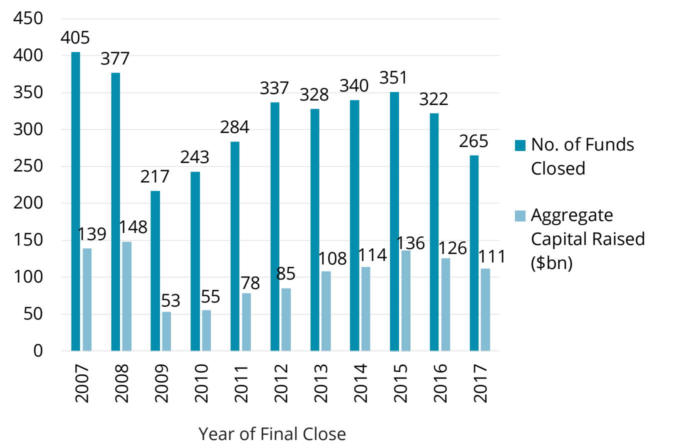
Source: Preqin

Fig. 2: Annual Capital Called up and Distributed by Closed-End Private Real Estate Fund Managers, 2004 - H1 2017



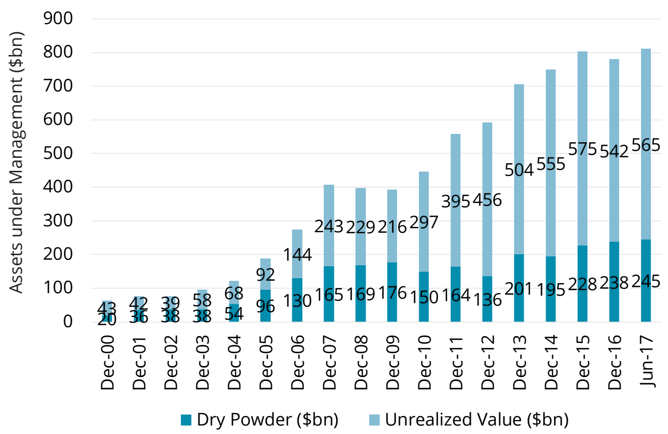
Source: Preqin

Fig. 3: Annual Closed-End Private Real Estate Fundraising, 2007 - 2017



Source: Preqin

Fig. 4: Closed-End Private Real Estate Assets under Management, 2000 - 2017



Source: Preqin

CHALLENGES AND KEY ISSUES

PRICING THE DOMINANT THEME

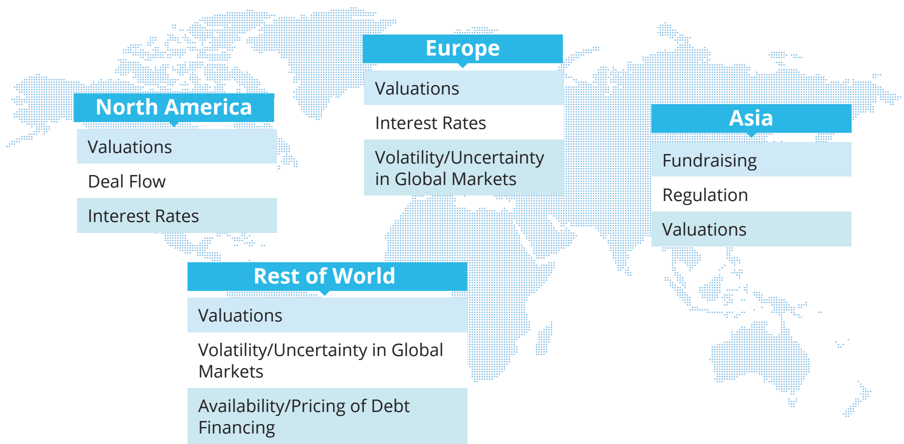
Globally, for the second year running, the pricing of assets has remained the key concern of private real estate firms, cited by 62% of respondents (Fig. 5). This proportion is 25 percentage points higher than the next biggest challenge for 2018, deal flow, which is intrinsically linked with valuations.

> ***Seventy-one percent of fund managers surveyed believe pricing for assets is higher than it was a year ago***

However, as each regional real estate market is at a different stage of development and presents distinct opportunities to investors, the issues faced by firms differ across regions. Fund managers operating from the developed real estate markets of North America and Europe have mirrored concerns of valuations and interest rates, whereas fundraising is the key concern for Asia-based firms.

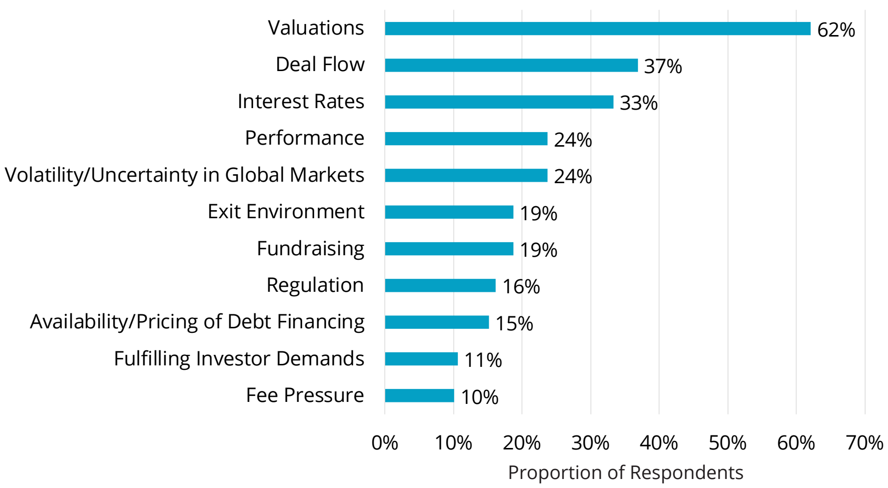
Seventy-one percent of fund managers surveyed believe pricing for assets is higher than it was a year ago. Driving this is the vast amount of capital at managers' disposal: $249bn as at December 2017,

Fund Managers' Top Three Issues for the Real Estate Market by Fund Manager Location:



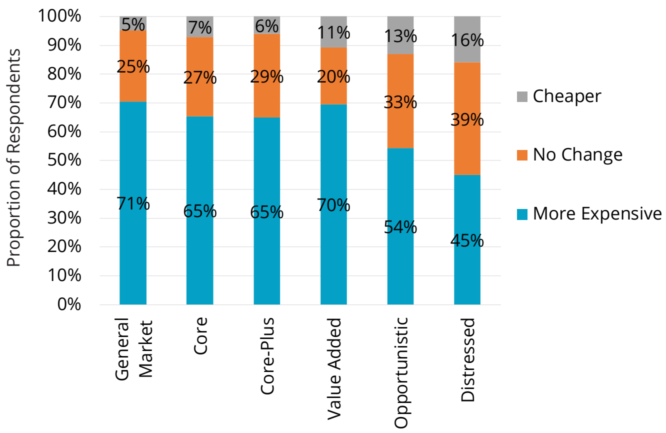
Source: Preqin Fund Manager Survey, November 2017

Fig. 5: Key Challenges Facing Private Real Estate Fund Managers in 2018



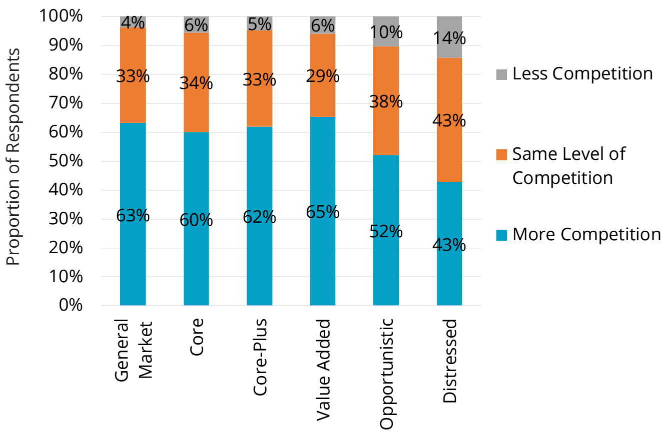
Source: Preqin Fund Manager Survey, November 2017

Fig. 6: Fund Manager Views on the Pricing of Real Estate Assets Compared to 12 Months Ago by Strategy



Source: Preqin Fund Manager Survey, November 2017

Fig. 7: Fund Manager Views on the Level of Competition for Real Estate Assets Compared to 12 Months Ago by Strategy



Source: Preqin Fund Manager Survey, November 2017

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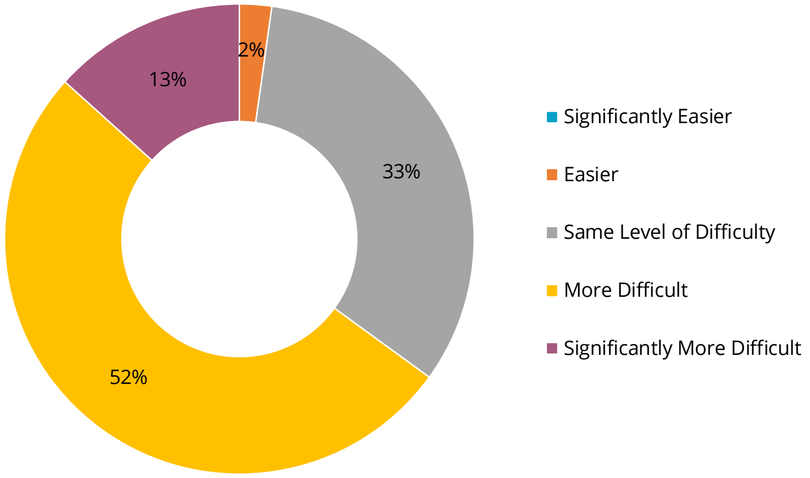
in conjunction with the increase in competition for transactions, not just from fund managers, but from institutional and strategic investors as well. One North America-based real estate fund manager stated that there is currently "higher investment demand than available deal placement".

Across the whole market, 63% of respondents have seen more competition for assets compared to the previous year (Fig. 7). Fund managers were invited to provide insight on the level of competition in distinct parts of the market:

- **Core/Core-Plus:** transactions involving stabilized assets in major gateway cities often capture media attention for large deal sizes, and as such is it is unsurprising that competition has continued to increase.
- **Value Added**: the largest proportion (65%) of surveyed fund managers reported greater levels of competition for assets slightly higher up the risk/return spectrum. This could be in response to high valuations for core/core-plus assets, with one Europe-based manager stating they are "moving away from prime [assets]", while another said they will be taking on "more risk".
- **Opportunistic:** while the majority (52%) of respondents have noticed more competition in this area of the market, the proportion is markedly smaller than that for value added property.
- **Distressed:** the distressed real estate market is smaller than others and so it is therefore unsurprising that the strategy recorded the smallest proportion (43%) of respondents that feel there is greater competition and the largest proportion (14%) that feel there is less.

Competition has had various effects on the operations of real estate firms. Sixty-five percent of respondents believe it is now harder to source attractive assets than a year ago (Fig. 8), and as a result, over a third are having to review more opportunities in order to find investments. For those looking to bring a fund to market, three out of five are having to reduce their targeted returns from levels they would otherwise have set if valuations remained steady. Others are looking at more creative ways to extract value by adapting their investment strategies, and some are looking towards other geographies or niche property types.

Fig. 8: Fund Manager Views on the Difficulty of Finding Attractive Real Estate Investment Opportunities Compared to 12 Months Ago

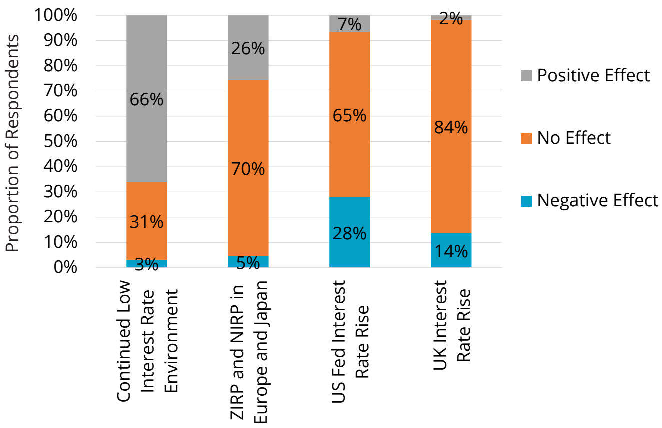


Source: Preqin Fund Manager Survey, November 2017

ANOTHER FACTOR TO CONSIDER – INTEREST RATES

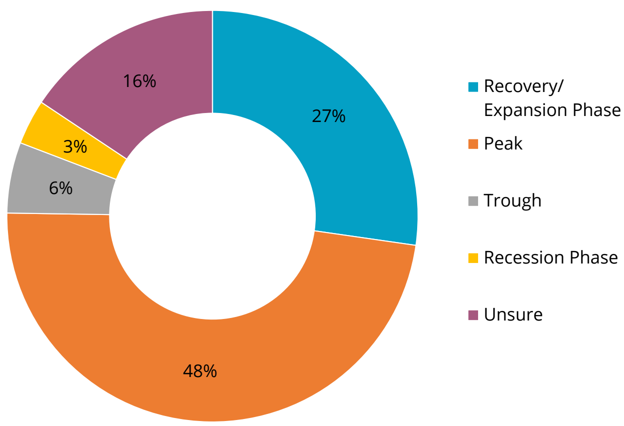
On the back of US and UK interest rate rises in 2017, and with further rises planned, concerns have been raised that we may be coming to the end of the historically low rate environment that has benefitted real estate investment and the growth of the asset class post-crisis. As seen in Fig. 9, greater proportions of real estate firms felt that fund performance was positively rather than negatively impacted by the continuation of the low rate environment and also by the interest rate policies enacted in Europe and Japan respectively. While the majority experienced no effect from rate rises in the US and UK, more respondents felt it had a negative effect on their 2017 real estate investments, with this proportion likely to rise over time alongside the Fed's and the BOE's planned policies.

Fig. 9: Fund Manager Views on the Impact of Interest Rate Policy on Real Estate Fund Performance over 2017



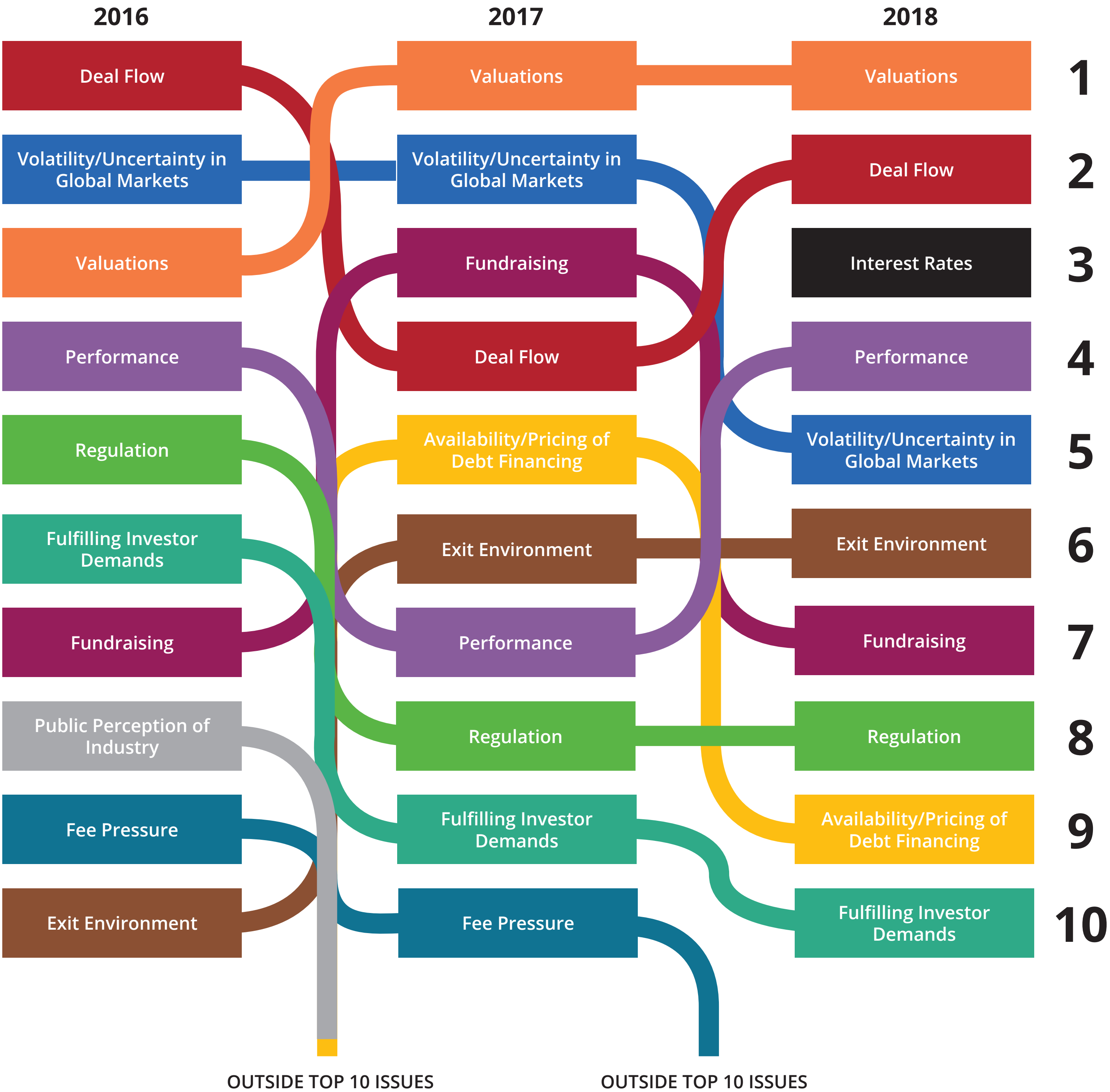
Source: Preqin Fund Manager Survey, November 2017

Fig. 10: Fund Manager Views on where Real Estate Is in the Current Market Cycle



Source: Preqin Fund Manager Survey, November 2017

FUND MANAGER VIEWS ON THE KEY CHALLENGES FACING THE REAL ESTATE MARKET



Source: Preqin Fund Manager Surveys, November 2015 - 2017

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FUND MANAGER VIEWS ON INVESTOR APPETITE

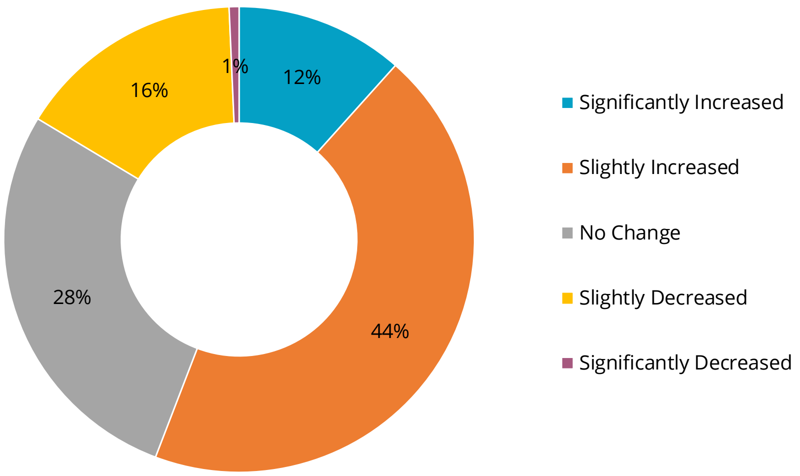
Three-quarters of the 215 real estate managers surveyed by Preqin in November 2017 experienced an increase in competition for institutional capital over the past 12 months. The sheer number of vehicles seeking capital (a record 573 as at January 2018) makes it a significant challenge for firms to stand out from the crowd. However, despite these difficulties, firms looking to raise capital in 2018 are approaching an investor base that appears to be satisfied with the asset class: 56% of managers surveyed reported an increase in investor appetite for real estate in the past 12 months, including 12% that cited a significant increase (Fig. 11).

Across all investor types, more fund managers have seen an increase in investor appetite for private real estate in the past 12 months than a decrease. The largest proportions of fund managers noted increased appetite from asset managers (39%), insurance companies (36%), private sector pension funds (36%) and, interestingly, retail investors (35%, Fig. 12). The transition to real estate investment for retail investors could be due to the yields on offer relative to fixed income where returns remain low.

Firms are seeing greater appetite across all regions, with the largest proportion (45%) of surveyed firms witnessing increased appetite from North America-based LPs (Fig. 13). However, the proportions reporting increased appetite from Europe- and Asia-based investors are not far behind at 38% and 40% respectively.

Despite the apparent increase in competition for capital, fund managers are likely to continue to see opportunities as institutional investors work towards their target allocations: 32% of investors interviewed by Preqin in December 2017 plan to increase their real estate allocations over the longer term.

Fig. 11: Fund Manager Views on How Institutional Investor Appetite for Private Real Estate Has Changed over the Past 12 Months



Source: Preqin Fund Manager Survey, November 2017

FUND MANAGERS REPORTING MORE COMPETITION FOR INVESTOR CAPITAL IN 2017

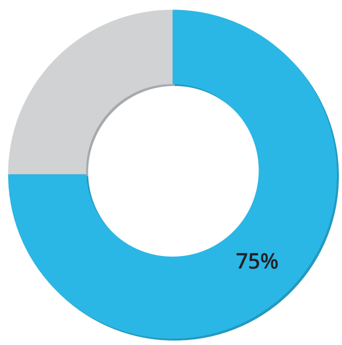
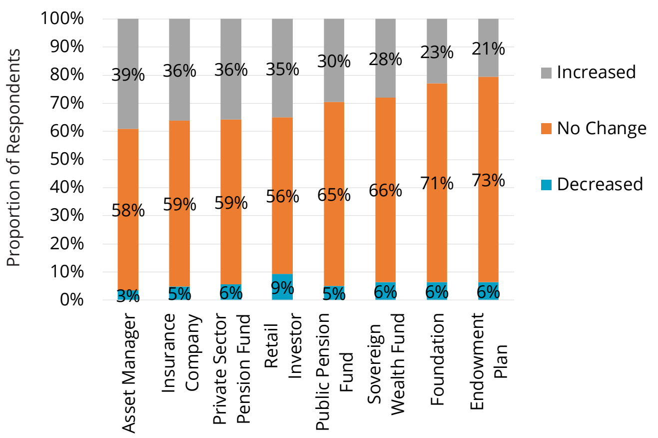
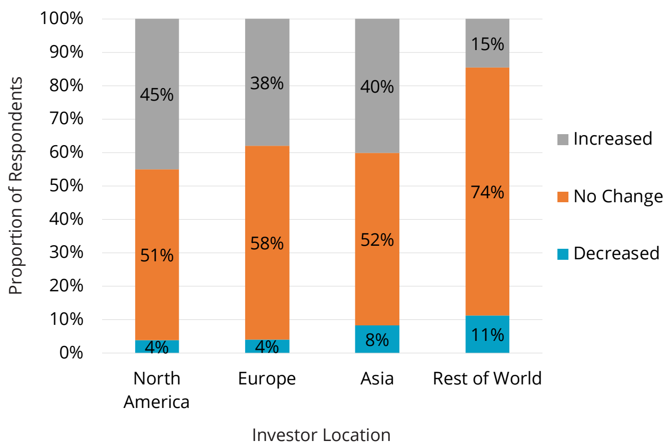


Fig. 12: Fund Manager Views on How Institutional Investor Appetite for Private Real Estate Has Changed over the Past 12 Months by Investor Type



Source: Preqin Fund Manager Survey, November 2017

Fig. 13: Fund Manager Views on How Institutional Investor Appetite for Private Real Estate Has Changed over the Past 12 Months by Investor Location



Source: Preqin Fund Manager Survey, November 2017

NORTH AMERICA AND EUROPE

KEY CONCERNS CITED BY NORTH AMERICA- AND EUROPE-BASED REAL ESTATE FUND MANAGERS FOR 2018:

NORTH AMERICA

- **73%** VALUATIONS
- **42%** DEAL FLOW
- **33%** INTEREST RATES

EUROPE

- **48%** VALUATIONS
- **42%** INTEREST RATES
- **38%** UNCERTAINTY IN GLOBAL MARKETS

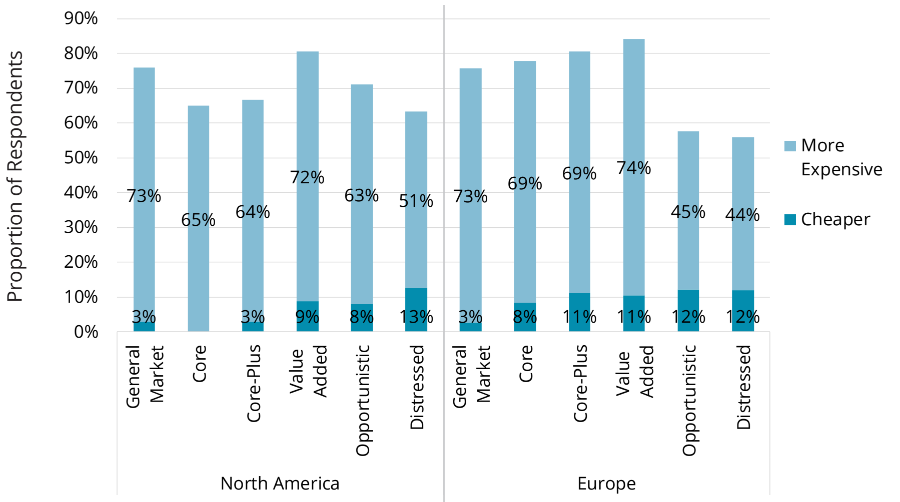
The emerging trends in the world's more traditional real estate markets are relatively similar to one another, however the differences appear in terms of scale. North America is the largest and most developed real estate market in the world, capturing the majority of investor capital commitments, and is the leading market for deal flow globally. As such, many of the global trends seen in this report are the trends of North America, and its challenges are the global fund communities' challenges.

Capital flows into Europe – which still account for a significant proportion of global fundraising – do not match the totals seen in North America. However, the growth in capital commitments from post-crisis levels to the highs seen in 2015 echo the fundraising pattern seen in North America.

> ***North America-focused funds hold more than $150bn in dry powder, while Europe-focused funds hold close to $60bn***

With strong fundraising across both regions, dry powder has continued to rise; North America-focused vehicles hold more than $150bn in available capital, and funds targeting European investment, hold close

Fig. 14: North America- and Europe-Based Fund Manager Views on the Pricing of Real Estate Assets Compared to 12 Months Ago by Strategy



Source: Preqin Fund Manager Survey, November 2017

to $60bn. With high amounts needing to be invested in a limited timeframe, and the overall rise in competition for assets across all sectors in these markets, pricing pressure has continued to intensify in the past 12 months.

PRICING PRESSURE

High valuations are the main issue across both North America and Europe – however, this is not restricted to just one area of the market. Real estate fund managers based in each region have seen more expensive assets in 2017 relative to the general market a year prior, which is also apparent across the risk/return spectrum of assets available for acquisition (Fig. 14). As such, the prevailing view from managers operating out of these regions is that we have reached the peak of the cycle, although the level of uncertainty is higher for Europe-based firms than their counterparts across the Atlantic.

Can this continue? Sixty-three percent of North America-based and 56% of Europe-based real estate firms plan to deploy more capital over 2018 than they did in 2017, with only 5% and 12% respectively planning to commit less. Couple this with the fact that competition for assets – not just from other firms, but also among institutional investors – has continued to rise across the board in both regions and we could see further rises in pricing over 2018. Most firms do not believe that there

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will be a significant correction in the next year, and in fact, approximately two-thirds of North America- and Europe-based managers believe that industry assets will continue to grow over the next year.

However, if this environment continues, it will become more difficult than it is currently to source attractive assets, with firms having to conduct more thorough due diligence per investment to ensure it has the right characteristics for their portfolio and strategy. Only 1% of North America-based respondents found it easier to find attractive opportunities over 2017 than they did in 2016, with 71% finding it more difficult; in Europe, no firms found it easier and 61% found it more challenging (Fig. 15).

INTEREST RATES

The low interest rate environment has been a major factor in the growth of the asset class in North America and Europe, and has made real estate particularly attractive for institutional investors. However, with inflation starting to rise, and economies performing strongly in the US and many countries in the eurozone, central bank policy is starting to shift. The end of 2017 saw the Federal Reserve and the Bank of England increase interest rates, along with a general tightening of the ECB's loose monetary policy which we have seen in the years following the Global Financial Crisis.

Thirty-seven percent of real estate managers in North America believe that the Federal Reserve's rate rise will have a negative effect on fund performance, while only 9% believe it will have a positive effect. In Europe, rate rises seem to be having less of an effect, with 93% and 81% of firms headquartered in the region predicting that rate rises in the US and UK respectively will have no effect on fund performance.

> ***"Without a significant correction in pricing many of the trends that have prevailed in recent years will continue to intensify***

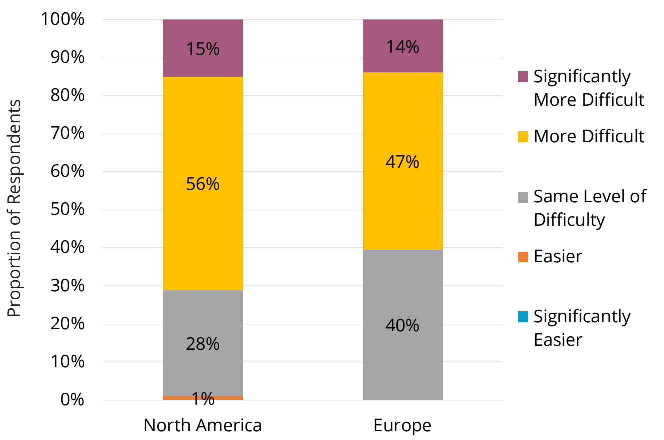
OUTLOOK

Without a significant correction in pricing, many of the trends that have prevailed in recent years will continue to intensify. While this means that investment in some areas of the more traditional markets will become more challenging, the options available to fund managers in North America and Europe mean that firms have many opportunities to pivot their focus, whether it be to less saturated sectors or to different markets within each region.

Europe has its own issues to contend with: the region is not immune to the political uncertainty surrounding the future of the UK – one of the biggest real estate markets in Europe – and its future relationship with the EU. Many in the industry are still waiting for some indication of what the future holds in terms of inbound and outbound investment and whether regulations will be altered.

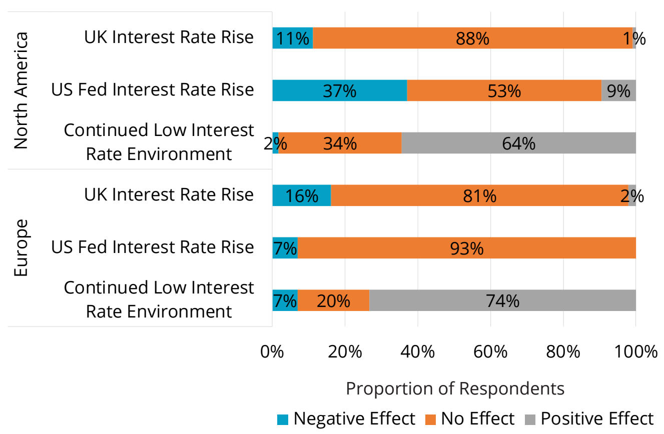
In times of uncertainty, investors are looking to place their capital in relative safety; when we interviewed 244 real estate investors at the end of 2017, most cited North America or Europe as presenting the best opportunities in the current market. However, they now face the challenge of having to find a way to isolate the best performers in an incredibly competitive fundraising environment.

Fig. 15: North America- and Europe-Based Fund Manager Views on the Difficulty of Finding Attractive Investment Opportunities Compared to 12 Months Ago



Source: Preqin Fund Manager Survey, November 2017

Fig. 16: North America- and Europe-Based Fund Manager Predictions for the Effect of Interest Rate Policy on Fund Performance in 2018



Source: Preqin Fund Manager Survey, November 2017

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ASIA & REST OF WORLD

KEY CONCERNS CITED BY ASIA & REST OF WORLD-BASED REAL ESTATE FUND MANAGERS FOR 2018:

41% VALUATIONS

28% UNCERTAINTY IN GLOBAL MARKETS

28% FUNDRAISING

The fundraising markets outside North America and Europe are far smaller than their more traditional counterparts. Fundraising has never truly recovered from 2008 totals, and the levels of capital raised annually in recent years have remained stagnant. However, the crisis did create opportunities for local firms, which started to secure capital commitments when international capital dried up in the aftermath. The community has placed a premium on local knowledge of property markets, and those firms that have the experience and relationships to source assets and navigate the varied regulatory landscapes.

CHALLENGES

As with North America and Europe, valuations are the biggest issue for Asia & Rest of World-based (ROW) real estate firms at present; however, when focusing on just Asia-based respondents, fundraising remains the dominant issue, and pricing ranks third. This is a notable change for these managers, where pricing has not historically been a major concern. Fig. 17 shows how pricing has shifted in both the general market and across the risk/return spectrum for Asia & ROW-based respondents. The prevailing view is that assets have become more expensive in 2017 relative to 2016; however, there are exceptions, particularly in capital appreciation strategies like opportunistic and distressed real estate, where assets are considered cheaper than a year ago.

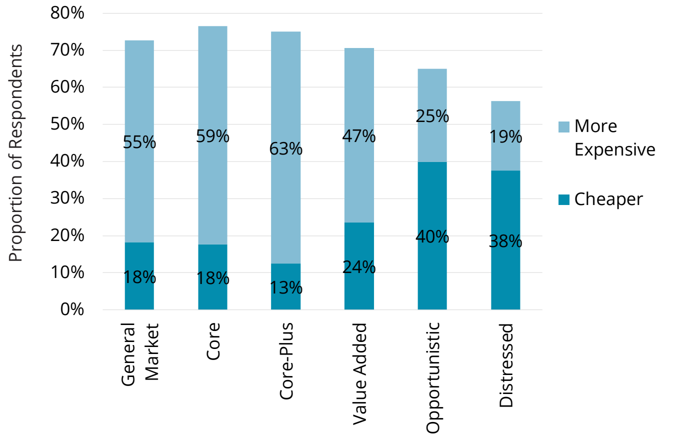
Despite this, Asia & ROW-based managers have reported more competition for transactions – especially for core and core-plus assets. Furthermore, contrasting with managers in the traditional markets, less than a quarter of Asia & ROW-based managers feel the real estate cycle has peaked. As such, they are more bullish regarding their activity in 2018: 84% plan to increase the amount of capital they deploy in assets relative to 2017 totals, including 56% that will significantly increase this total.

OUTLOOK

The difficulty for institutional investors targeting Asia & ROW markets is the different levels of development and the varied economic, social and regulatory environments which can make long-term investment challenging. However, there is also strength in this diversity, which fulfils institutions' desire for portfolio diversification, and there is a chance for outsized returns due to the strong economic growth, which has been stunted in more developed markets in recent years.

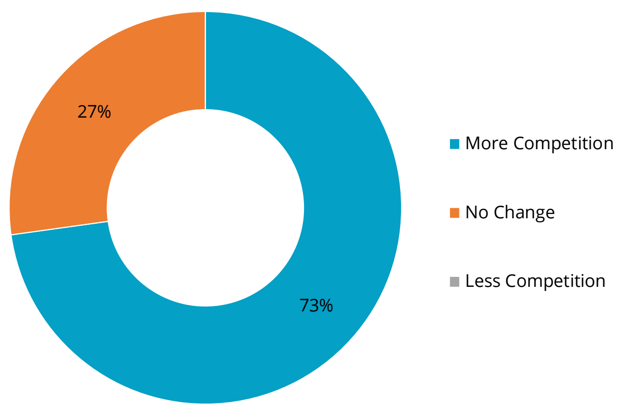
However, competition for investor capital is increasing: 73% of Asia & ROW-based fund managers feel there is now more competition for commitments than 12 months ago, while no respondents feel there is less (Fig. 18). Furthermore, they are facing the issue of trying to stand out from the crowd in an environment where investors are generally more risk averse, believing the best opportunities lie in North America and Europe.

Fig. 17: Asia & Rest of World-Based Fund Manager Views on the Pricing of Real Estate Assets Compared to 12 Months Ago by Strategy



Source: Preqin Fund Manager Survey, November 2017

Fig. 18: Asia & Rest of World-Based Fund Manager Views on the Level of Competition for Investor Capital in 2017 Compared to 12 Months ago



Source: Preqin Fund Manager Survey, November 2017

CHALLENGES OF SIZE

While fundraising has been relatively strong in the last few years – with five consecutive years of $100bn or more being secured for closed-end real estate vehicles – the annual number of funds closed since 2015 has declined significantly (see page 3). Increasingly, capital is becoming concentrated among a select group of managers, typically those that have the longest and strongest track records. Illustrative of how concentrated the market has become, the 10 largest funds closed in 2017 secured a third of the total capital raised, while the top 20 funds captured half of capital commitments. As such, the challenges faced by smaller firms (those with less than $250mn in AUM) can differ significantly from mid-sized ($250-999mn) and large managers ($1bn or more).

CHALLENGES

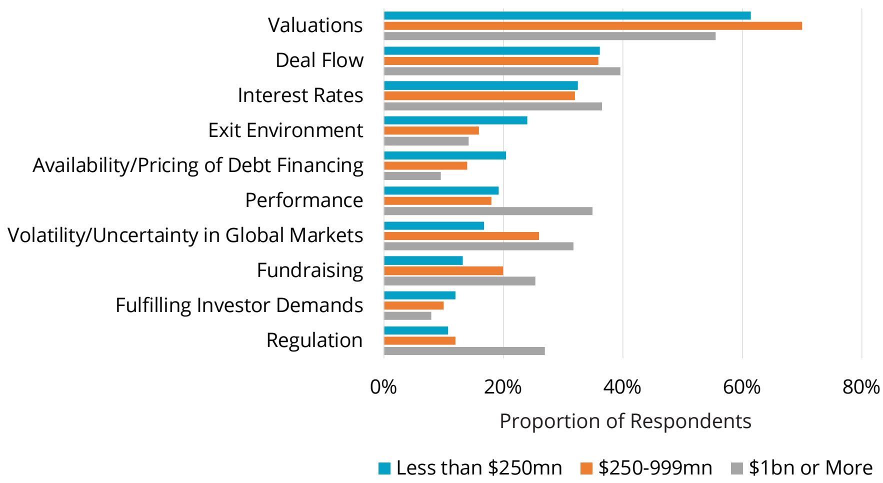
The top issues facing real estate firms are aligned for fund managers of all sizes – namely valuations, deal flow and interest rates (Fig. 19). Pricing is an issue for more small and mid-sized firms than large managers, and there is greater disparity in the proportions of respondents concerned by valuations than by deal flow. Interestingly, as AUM declines, more respondents are concerned with the exit environment, the availability and pricing of debt financing and fulfilling investor demands, while the reverse is true for uncertainty in global markets, fundraising and regulation.

Asset pricing is becoming more expensive for managers of all sizes – in line with global trends across all strategies – while competition is also rising universally. As such, the prevailing view among managers of all sizes is that we are at the peak of the real estate market (Fig. 20). However, more mid-sized and large firms believe there is still room to grow in the market than their smaller counterparts.

ACTIVITY

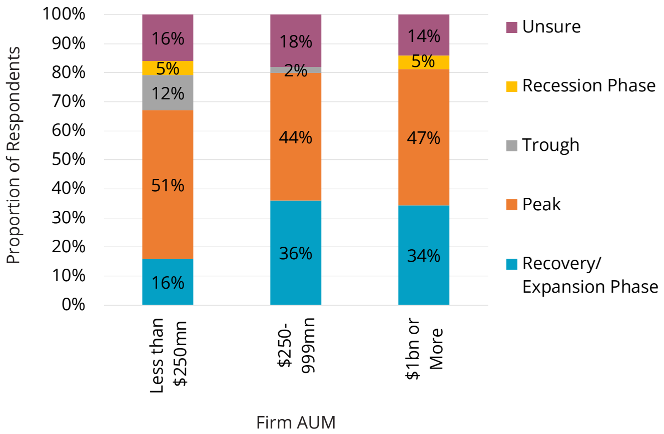
While all fund managers plan to deploy more capital in real estate in 2018 than they did in 2017, the proportion of respondents deploying more capital decreases as firm AUM increases: 71%

Fig. 19: Fund Manager Views on the Key Issues Facing the Real Estate Industry in 2018 by Firm AUM



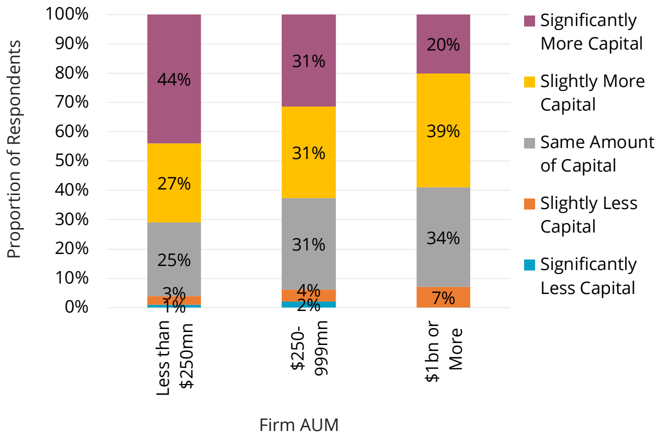
Source: Preqin Fund Manager Survey, November 2017

Fig. 20: Fund Manager Views on where Real Estate Is in the Current Market Cycle by Firm AUM



Source: Preqin Fund Manager Survey, November 2017

Fig. 21: Amount of Capital Fund Managers Plan to Deploy in Real Estate Assets in the Next 12 Months Compared with the Past 12 Months by Firm AUM



Source: Preqin Fund Manager Survey, November 2017

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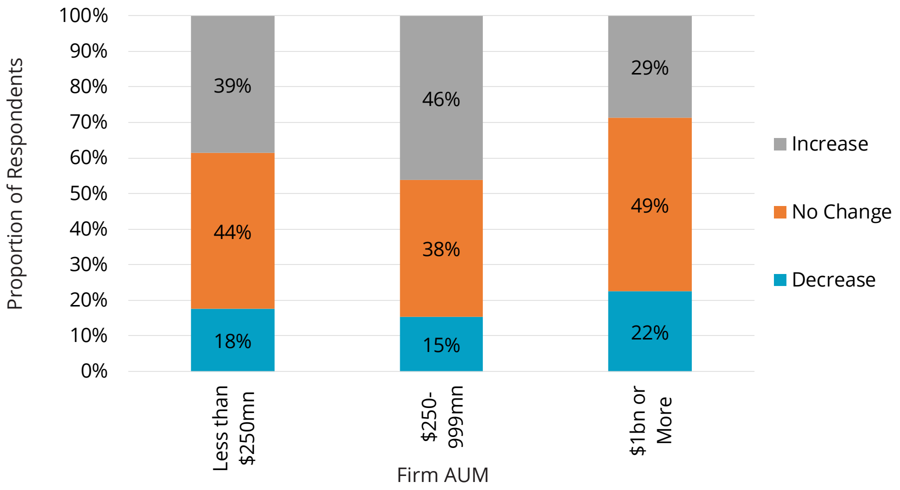
of the smallest firms plan to deploy more capital compared with 59% of the largest (Fig. 21). In terms of exits, more respondents are planning to increase their activity over 2018 relative to 2017 than to reduce this, particularly among smaller and mid-sized firms, as seen in Fig. 22.

Fig. 22: Fund Managers' Planned Level of Exit Activity over the Next 12 Months Compared to the Previous 12 Months by Firm AUM



Source: Preqin Fund Manager Survey, November 2017

INVESTOR APPETITE

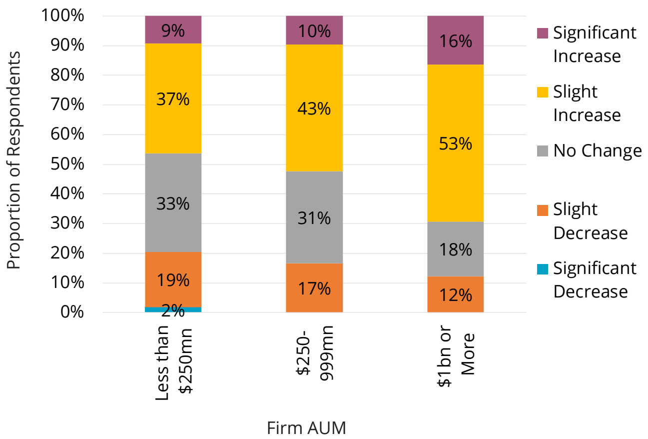
In line with the strong performance and high distributions of recent years, satisfaction with the real estate asset class is high, and as such managers have seen a rise in institutional investor appetite over the course of 2017. Furthermore, it is unsurprising to see that – in an environment where track records are key determinants of commitments – that the larger the firm, the more likely they are to have seen an increase in investor appetite for real estate over 2017 (Fig. 23).

With a record number of funds in market, surveyed fund managers have seen an increase in competition for capital over 2017. This is particularly apparent for those managers in the mid-market space – with the largest number of funds in market – where no respondents noted a decrease in competition for capital (Fig. 24).

OUTLOOK

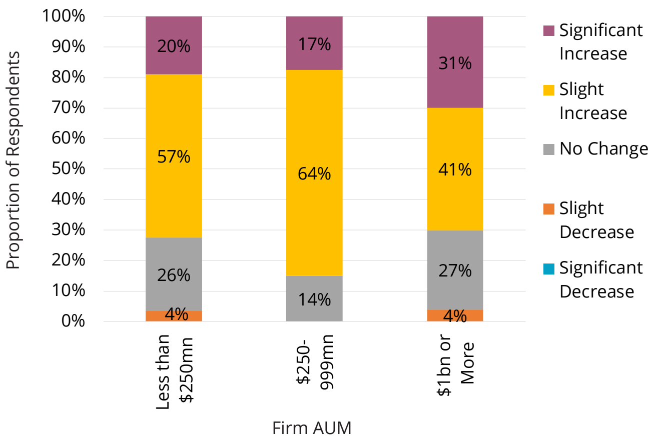
Smaller funds have the capacity to generate higher returns than their larger peers and can often act faster than larger organizations. However, investors – with one eye looking to the challenges facing the industry – are lowering the risk tolerance in pursuit of managers that have the networks to maintain pipelines and a history of investing over difficult periods. As pricing pressure and capital competition intensifies it is expected that the established managers will continue to dominate the fundraising environment. This is evidenced by the fact that first-time funds – generally raised by smaller firms – constitute approximately a quarter of all funds in market, but just 13% of the aggregate capital targeted. Conversely, the most experienced managers (those that have raised nine or more funds previously) are seeking to raise just 13% of the number of funds in market yet 30% of all targeted commitments.

Fig. 23: Fund Manager Views on How Institutional Investor Appetite for Real Estate Has Changed over 2017 by Firm AUM



Source: Preqin Fund Manager Survey, November 2017

Fig. 24: Fund Manager Views on the Level of Competition for Institutional Investor Capital over 2017 by Firm AUM



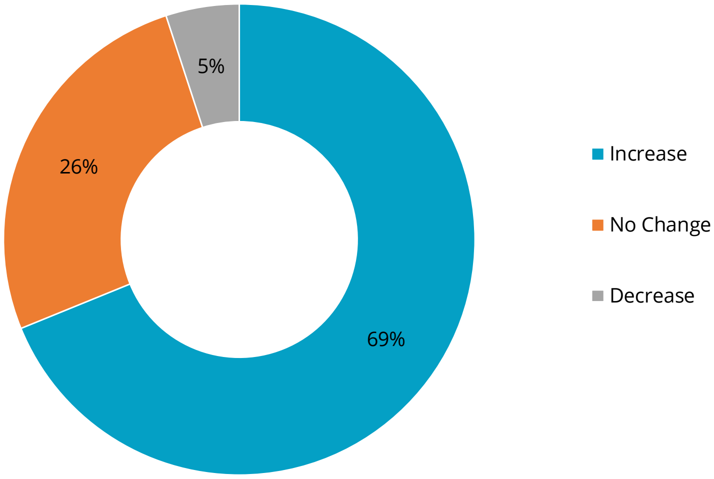
Source: Preqin Fund Manager Survey, November 2017

THE YEAR AHEAD

TIMING THE MARKET

The current environment has amplified concerns about where we currently are in the market cycle. Nearly half of private real estate firms surveyed believe we have reached the peak of the market. However, regionally, this proportion decreases as we move east from North America. Fifty-three percent of North America-based real estate firms feel we are now at the peak of the market, compared to 49% of Europe-based respondents and just 24% of Asia & ROW-based firms. Despite this, there remains a significant 30% of North America-based firms that feel there is still room to grow, while Europe-based respondents were more unsure.

Fig. 25: Fund Manager Predictions for the Size of the Private Real Estate Industry in the Next 12 Months



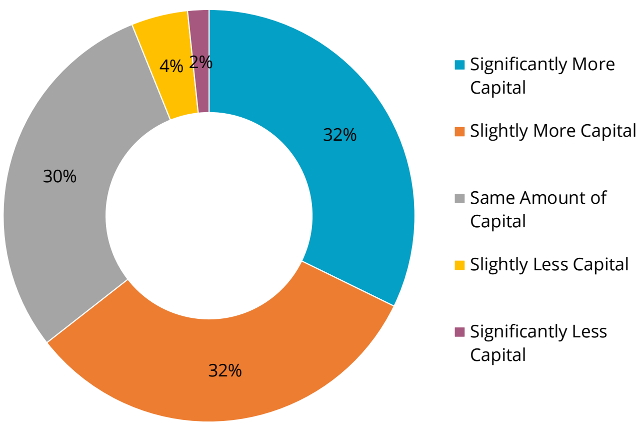
Source: Preqin Fund Manager Survey, November 2017

> ***Nearly two-thirds of surveyed firms intend to deploy more capital in 2018 than they did in 2017***

However, real estate fund managers surveyed do not believe a correction is imminent, with 69% predicting that industry assets will grow over the next year (Fig. 25). Firms remain keen to put their capital to work, with 64% planning to deploy more capital in property over 2018 than they did in 2017, while only 6% intend to invest less (Fig. 26). This includes nearly a third that expect to deploy significantly more capital over the next year.

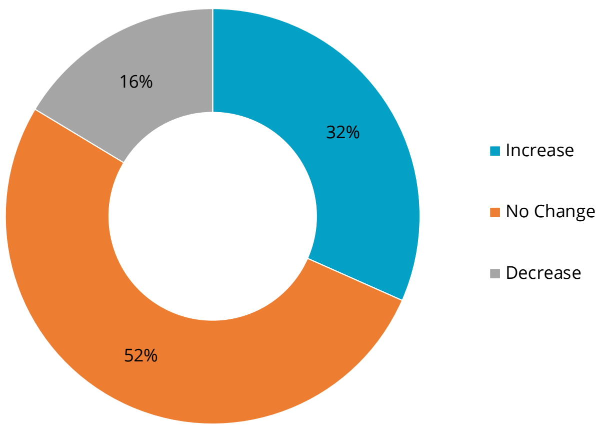
What does this mean for 2018? Without a significant correction, the capital available to fund managers (approximately a quarter of a trillion dollars as at December 2017) means we are likely to see a continuation of trends that have persisted in recent years: a high level of competition for transactions and upwards pricing pressure. The other side of the coin is a continuation of the strong seller's environment – double the proportion of respondents plan to increase their exit activity over 2018 than reduce it (Fig. 27). However, fund managers are still confident that they can source attractive opportunities and deliver the level of performance that institutional investors have come to expect from the asset class.

Fig. 26: Amount of Capital Fund Managers Plan to Deploy in Real Estate Assets in the Next 12 Months Compared to the Past 12 Months



Source: Preqin Fund Manager Survey, November 2017

Fig. 27: Fund Managers' Planned Level of Exit Activity in the Next 12 Months Compared to the Past 12 Months



Source: Preqin Fund Manager Survey, November 2017

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