PREQIN QUARTERLY UPDATE: REAL ESTATE Q3 2019

Insight on the quarter from the leading provider of alternative assets data

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Fundraising
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Foreword

With the threat of slowing economic growth and increasing political risk, the final quarter of 2019 is shrouded in uncertainty. Private real estate industry participants will have important questions to answer in such conditions. How can smaller managers raise equity after so much capital consolidation? How will larger managers put their money to work amid intense competition for assets and high valuations? And how will investors meet their target allocations to the asset class after net distributions have been so high over the past six years?

These are certainly important problems to solve, but the vital signs for private real estate are not all negative as we look ahead to the next three months.

Investors are still looking to put their money towards real estate, albeit in smaller quantities than this time last year, while fund managers continue to bring record numbers of funds to market. Blackstone raised the largest ever closed-end private real estate fund in Q3, while opportunistic fundraising is on track to reach its second-highest total. As the industry searches for stability, there has been an uptick in fundraising for lower-risk strategies, with core and core-plus funds already outpacing full-year 2018 fundraising. Notably, high levels of capital have been raised by a very small number of funds in Q3 – half the number closed in Q3 last year.

Broadly, industry fundamentals appear strong, even as we approach the increasingly uncertain end of the year. Investor appetite for the asset class persists, and the dry powder is there, waiting to be spent on the right deals.

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PropTech: How Technology Is Transforming the Real Estate Industry

From big data to AI, a wave of emerging technological innovations is reimagining real estate operations

PropTech is part of a wider digital transformation in the real estate industry. In this Q&A, **Troy Merkel** (Partner, Real Estate Analyst) and **Scott Helberg** (Real Estate Senior Analyst) from RSM share their views on how technology is being used to deliver value to the real estate market. They discuss the advantages of replacing inefficient systems, and the sectors and geographies that are implementing and benefitting from PropTech across the industry.

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What is PropTech, and what does it mean for the real estate industry?

TM: PropTech is the leveraging of artificial intelligence (AI), machine learning, robotics, robotic process automation, big data and blockchain. These emerging technologies are drastically impacting the way business is done today, and are being applied to real estate across a variety of verticals. This can be on the brokerage and leasing side, property development or investment and financing, and in the way that managers are interacting with their investors.

What are the main benefits that PropTech can provide asset owners?

SH: We are in a day and age where people want their information accurately, on demand and as quickly as possible. The implementation of PropTech is vital for investors: they can get the information they want immediately, but also in their desired format. If you have two investors looking for potentially different formats or metrics of information, PropTech is vital for fund managers to be able to provide that at a reasonable cost and pass the information on without any obligation.

Would that be implemented specifically for the investor? Would it take time to build out or is it a quick process?
TM: While there may be customization requests from investors, the implementation of the platform and the benchmarking and analytics is quick and easy. However, the biggest issue we see is ensuring that the underlying structure of the data is accurate. If the infrastructure isn't built correctly, you will begin to see cracks in the system, and it won't work.

How can PropTech deliver value in a market?
SH: It can really help in two key ways. One is on a tenant-facing front, depending on your asset, i.e. whether it's residential, office or retail. There are various end consumers, and in the future people will become even more interconnected with the implementation of 5G – you are going to need PropTech, which is tenant facing, to make the end customer happy. But it's also about the data you have access to – whether it's on the investor side or the asset-owner side – getting access to that data, organizing it and optimizing it so that you can leverage it appropriately in order to maximize revenue or minimize cost.

TM: Secondly, with cost reduction, sustainability is a big driver. When people think of sustainability, they think about saving consumed energy, leveraging smart devices, algorithms, machine learning and optimizing the electricals within a building. It's important to be proactive and identify potential risk – 5G for example will allow so many more devices to be connected. You begin to see buildings retrofitting some of this technology, and as a result you see 25-40% reductions in utility costs. Companies like OpenSpace exist, which leverage AI systems to understand how people work and how workflow happens within a building in order to optimize. The buildings themselves may start to evolve but a lot of it is about how we use those buildings and how we can best use them in a more sustainable way.

Are certain sectors particularly invested in PropTech?
SH: I think it's across the board, but where we're probably seeing the largest driver is on the residential side. Generally, more millennials sign apartment leases than office leases, and millennials have greater purchasing power. And since they are more adept at technology, and have a greater need for instant information and data, there's going to be more of a push for PropTech. But, that doesn't mean it isn't happening in other sectors.

Which is the main market for PropTech?
SH: It's happening globally, but the US is clearly the hub both from a fundraising perspective and in terms of where PropTech firms are located. We have seen huge cash flows both in Europe and in Asia – I recently saw that 60% of PropTech capital over the past five years was going towards Asia. From what we have seen, the implementation behind that was a little slower, but I don't think you're necessarily seeing that level in tech hubs like Silicon Valley. Generally, PropTech focuses where there is a large amount of real estate, as that's where those ideas can be implemented effectively. The New York and London areas are therefore seeing the highest density of PropTech.

What are the benefits of being an early PropTech adopter?
TM: There is a benefit to being an early adopter, but many firms are looking to be fast followers. Smaller private equity funds are not going to have the capital dedicated to this in comparison to other larger PropTech and brokerage firms that are currently investing heavily into it.

What advice would you give to fund managers looking to implement PropTech who might not be there yet?
TM: If I had to give advice to those funds, the first is to build a strategy roadmap in order to work out a vision for the future. Make sure you structure your data appropriately and accurately. Moving forwards, you can select the individual projects or process improvements required and then start to look for solutions for these. Lastly, you need to approach this almost as an opportunistic real estate investment fund – and that means accepting that not all new technologies will succeed or be the right solution.

About RSM US LLP

RSM's purpose is to deliver the power of being understood to our clients, colleagues and communities through world-class audit, tax and consulting services focused on middle-market businesses.

For more commentary from RSM, visit Preqin's blog channel or contact +1 (800) 274 3978.

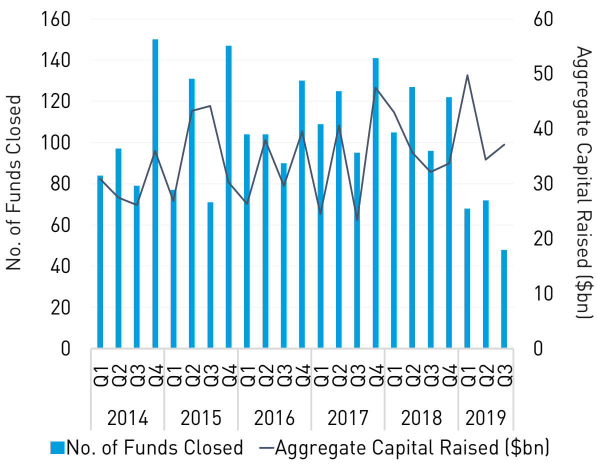
Fundraising

Private real estate fundraising momentum continued in Q3; $121bn has been secured so far in 2019, keeping the year on track to break the annual fundraising record (Fig. 1). Continuing the trend of capital consolidation, only 48 funds closed in the quarter. Together these funds raised $37bn, at an average of $843mn per fund, although this is tremendously skewed by the closing of Blackstone Real Estate Partners IX on $20.5bn.

Funds focused on North America once again dominated the market, with 28 funds accounting for 76% of aggregate capital raised (Fig. 2). Investors continued to favour value-added and opportunistic strategies: 20 and 12 such funds closed respectively (Fig. 3).

Among private real estate funds closed so far in 2019, two-thirds have either achieved or surpassed their targets (Fig. 4). Fund managers are also completing these raises in less time, with 88% of funds closing inside 24 months, compared to 82% in 2018 (Fig. 5).

Fig. 1: Global Quarterly Closed-End Private Real Estate Fundraising, Q1 2014 - Q3 2019



Source: Preqin Pro

Blackstone Real Estate Partners IX became the largest private real estate fund of all time in September (Fig. 6). Following in the wake of Brookfield Strategic Real

Fig. 2: Closed-End Private Real Estate Fundraising in Q3 2019 by Primary Geographic Focus

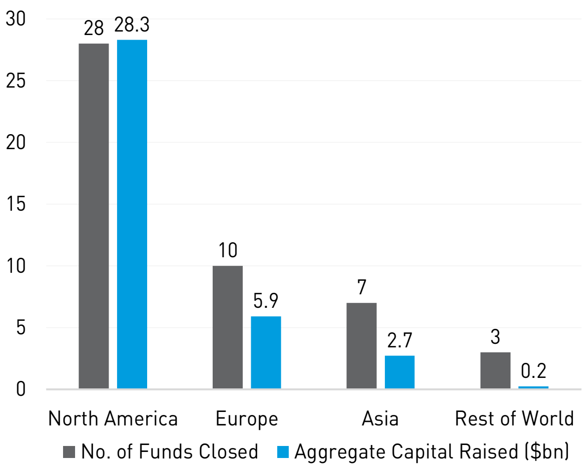


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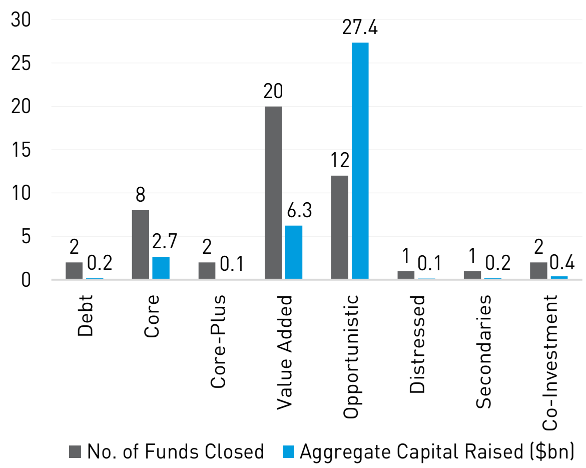
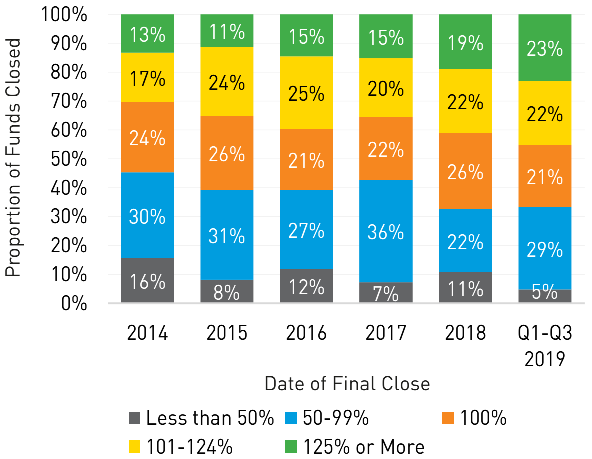
Fig. 3: Closed-End Private Real Estate Fundraising in Q3 2019 by Primary Strategy



Source: Preqin Pro

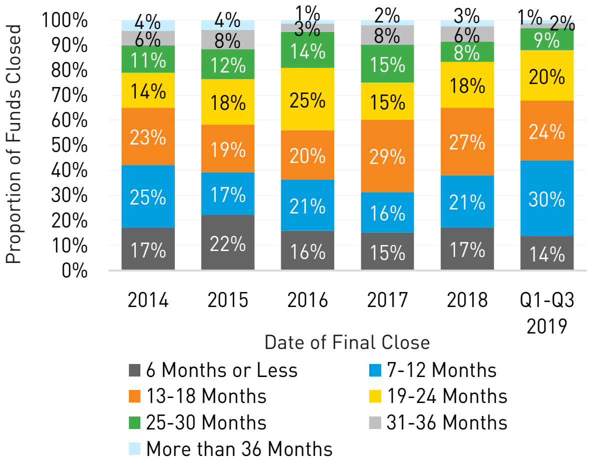
Estate Partners III's $15bn closure earlier in the year, the more experienced, blue-chip fund managers are successfully attracting the majority of capital commitments.

Fig. 4: Proportion of Target Size Achieved by Closed-End Private Real Estate Funds Closed, 2014 - Q1-Q3 2019



Source: Preqin Pro

Fig. 5: Time Spent in Market by Closed-End Private Real Estate Funds Closed, 2014 - Q1-Q3 2019



Source: Preqin Pro

Fig. 6: Largest Closed-End Private Real Estate Funds Closed in Q3 2019

Fund	Firm	Fund Size (mn)	Final Close Date	Primary Strategy	Geographic Focus	Primary Property Focus
Blackstone Real Estate Partners IX	Blackstone Group	20,500 USD	Sep-19	Opportunistic	North America	Diversified
Ares European Real Estate Fund V	Ares Management	1,800 EUR	Aug-19	Opportunistic	Europe	Diversified
Bain Capital Real Estate I	Bain Capital Credit	1,518 USD	Jul-19	Value Added	North America	Niche
Fonds de Logement Intermédiaire 2	AMPERE Gestion	1,250 EUR	Sep-19	Core	Europe	Residential
Harrison Street Real Estate Partners VII	Harrison Street Real Estate Capital	1,300 USD	Aug-19	Opportunistic	North America	Niche
AG Asia Realty Fund IV	Angelo, Gordon & Co	1,300 USD	Sep-19	Opportunistic	Asia	Diversified

Source: Preqin Pro

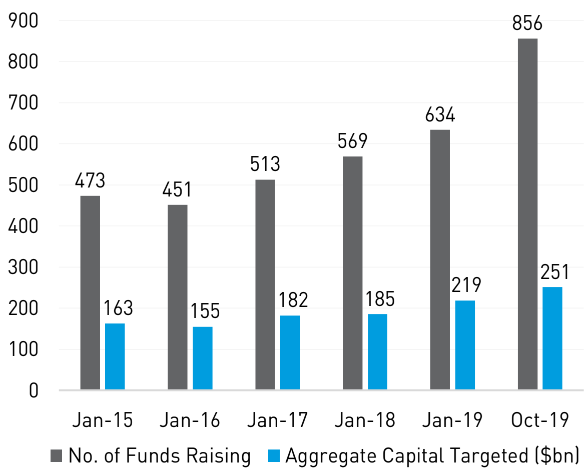
Funds in Market

After a slow start to the year, swathes of new private real estate funds have formed and been brought to market in the second half of 2019. As of October, there are 856 funds in market globally, seeking a combined $251bn from investors (Fig. 7).

As shown in Fig. 8, the majority (61%) of funds in market are targeting value-added and opportunistic strategies, where 60% ($150bn) of targeted capital is headed. Debt and core strategies also make up significant proportions of funds in market, targeting $35bn and $25bn respectively.

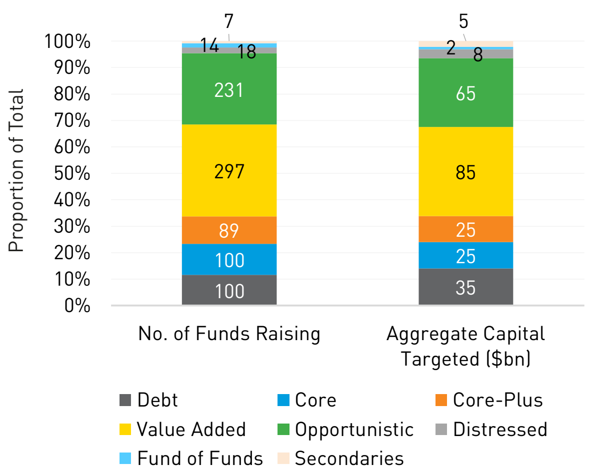
More than half (52%) of funds in market have already held an interim close, securing a combined $81bn – 32% of the total amount targeted (Fig. 9). This bodes well for funds that have just started fundraising; 69 funds have been in market for six months or less and a further 86 have been on the road for less than a year.

Fig. 7: Closed-End Private Real Estate Funds in Market over Time, 2015 - 2019



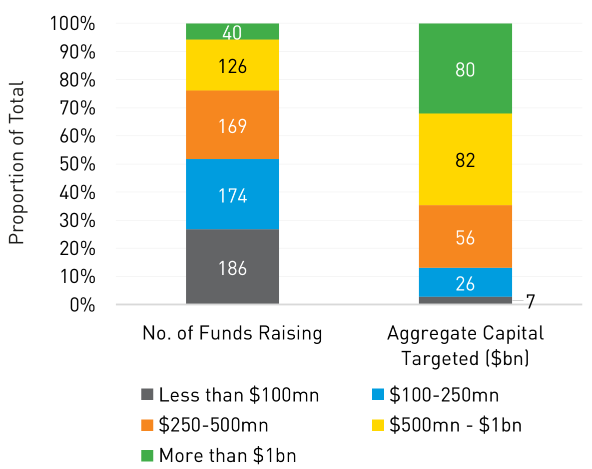
Source: Preqin Pro

Fig. 8: Closed-End Private Real Estate Funds in Market by Primary Strategy



Source: Preqin Pro. Data as of October 2019

Fig. 9: Closed-End Private Real Estate Funds in Market by Target Size



Source: Preqin Pro. Data as of October 2019

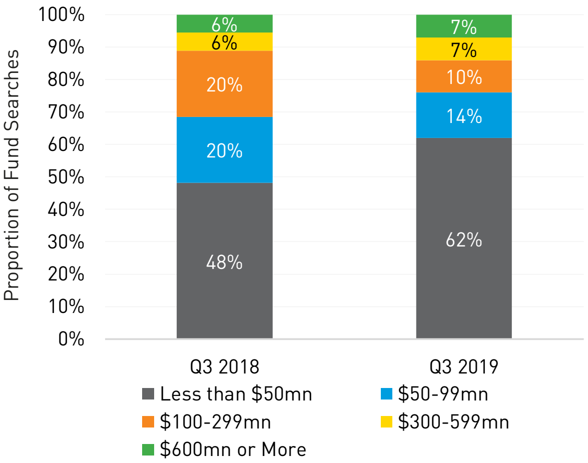
Investors

Investor confidence in real estate may have dampened in recent months. Sixty-two percent of investors plan to invest less than $50mn in fresh capital in the coming year, up 14 percentage points on Q3 2018 (Fig. 10). Either investors are demonstrating a cautious approach to minimize risk in the face of a potentially imminent market correction, or they are nearing the fulfilment of their target allocations. Additionally, the proportion committing $50-99mn is down six percentage points, and the proportion targeting commitments of $100-299mn has halved.

Low-risk strategies have attracted increased interest in Q3 2019, with 16% more investors targeting core than a year ago, and 17% more targeting core-plus (Fig. 11). Appetite for riskier strategies has dropped in contrast, with the share of investors targeting value-added funds decreasing by 14% and opportunistic by 9%.

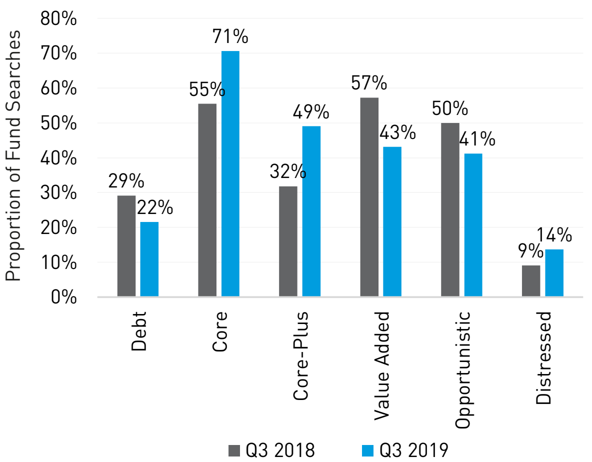
Investors appear to have shifted their focus somewhat away from North America, Asia-Pacific and emerging markets in favour of investment in Europe and Rest of World, which are the only regions to have recorded an uptick in interest as compared with Q3 2018 (Fig. 12).

Fig. 10: Amount of Fresh Capital Investors Plan to Commit to Private Real Estate Funds over the Next 12 Months, Q3 2018 vs. Q3 2019



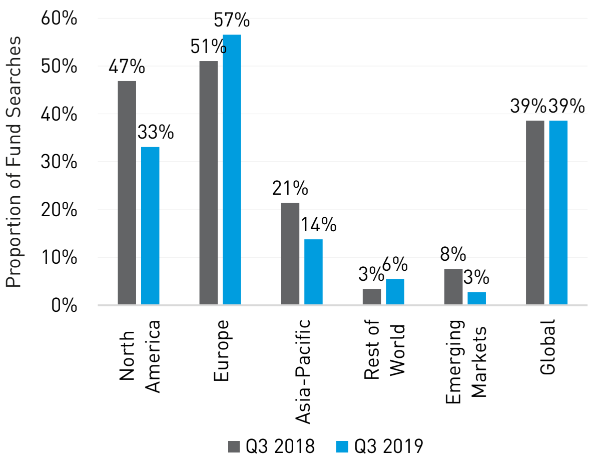
Source: Preqin Pro

Fig. 11: Strategies Targeted by Private Real Estate Investors over the Next 12 Months, Q3 2018 vs. Q3 2019



Source: Preqin Pro

Fig. 12: Regions Targeted by Private Real Estate Investors over the Next 12 Months, Q3 2018 vs. Q3 2019



Source: Preqin Pro

Deals

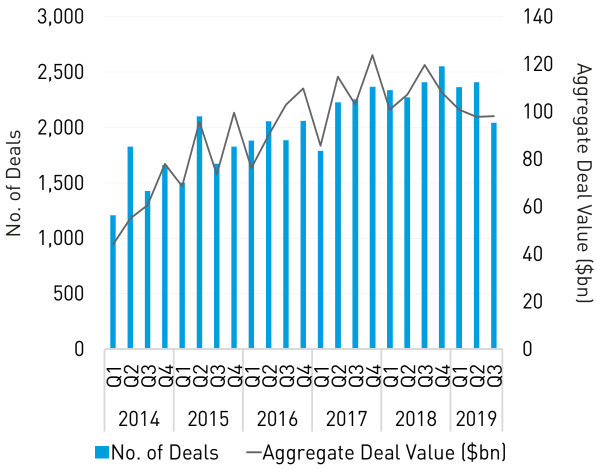
Ending the relative steady growth seen in private equity real estate (PERE) deal totals over the past few years, both the number and aggregate value of transactions has dropped off significantly in Q3 2019. Q3 2018 recorded 2,410 deals for an aggregate $120bn, compared with 2,044 deals for $98bn in Q3 2019 (Fig. 13).

The total number of deals has declined across each property type from Q3 2018, even in core property sectors where the bulk of PERE investments are historically made (Fig. 14).

Unsurprisingly, the trend is also negative for each region. The number of PERE deals in North America has dropped significantly from 1,727 deals in Q3 2018 to 1,428 deals in Q3 2019. In the same timeframe, deals in Europe have also decreased from 590 to 525 (Fig. 15).

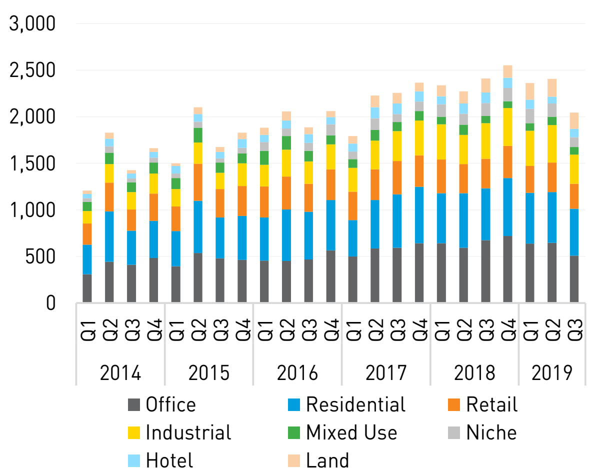
For overall transaction type proportions, however, levels have remained relatively similar. In Q3 2018, the proportion of single-asset deals to portfolio deals was 86:14 – in Q3 2019, the proportions were 84:16, indicating that while the numbers of deals have dropped significantly, the market shares for the types of deals remain relatively constant.

Fig. 13: Quarterly PERE Deals, Q1 2014 - Q3 2019



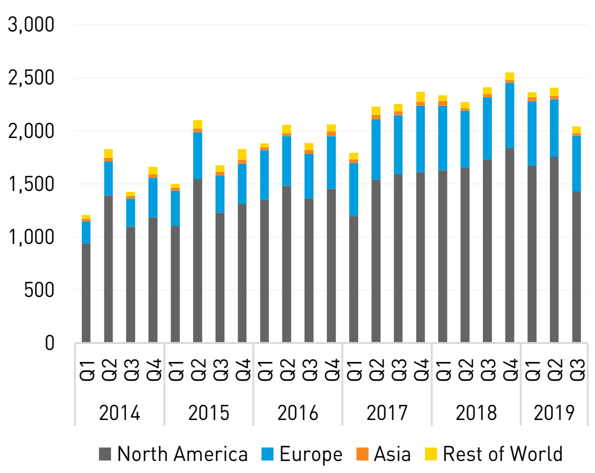
Source: Preqin Pro

Fig. 14: Number of PERE Deals by Property Type, Q1 2014 - Q3 2019



Source: Preqin Pro

Fig. 15: Number of PERE Deals by Region, Q1 2014 - Q3 2019



Source: Preqin Pro

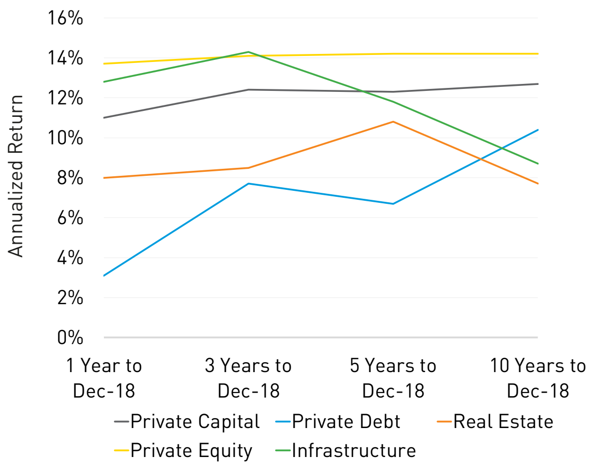
Performance

Fig. 16 shows the performance of real estate vehicles against other private capital asset classes over a one-, three-, five- and 10-year horizon to December 2018. Real estate underperforms all asset classes over every period barring private debt, which it outperforms across the one-, three- and five-year horizon, reaching double digits (+10.8%) for the five-year horizon.

In line with the high risk/return profile of the strategy, value-added real estate vehicles have almost entirely outperformed other strategies across the vintage years shown in Fig. 17. The volatility of this strategy is evident from its median net IRR high of 20.1% (vintage 2011), and low of 1.7% (vintage 2006). Debt vehicles have lived up to their reputation by producing consistent (but lower) median net IRRs across the vintage years examined. This strategy has seen returns hit a low of -1.2% (vintage 2006) and a high of 12.3% (vintage 2011).

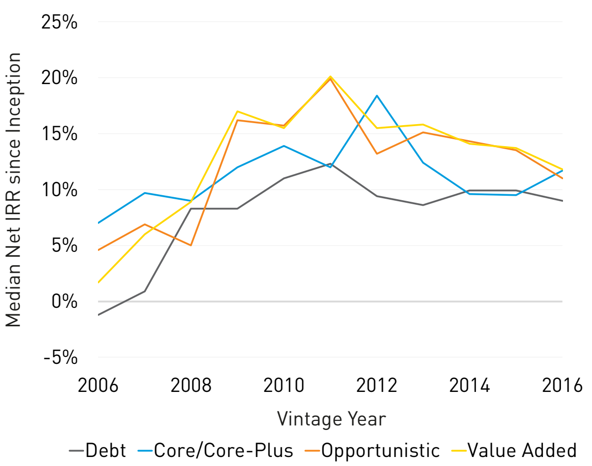
Investors have received total distributions of $180bn from their real estate portfolios in 2018, $31bn less than in 2017 – this also marks the second consecutive fall in annual capital distributed (Fig. 18). However, net cash flow in 2018 was still positive at $24bn.

Fig. 16: Horizon IRRs by Asset Class



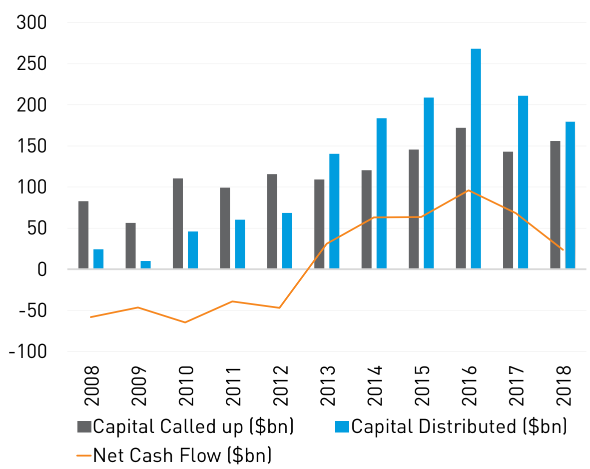
Source: Preqin Pro

Fig. 17: Closed-End Private Real Estate: Median Net IRRs by Strategy and Vintage Year



Source: Preqin Pro

Fig. 18: Closed-End Private Real Estate: Annual Capital Called up, Distributed and Net Cash Flow, 2008 - 2018



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