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LPs need to be ‘realistic’ over further fund write-downs

Limited partners urged to start serious discussions with GPs about portfolio and asset valuations, as institutional investors attempt to choose tomorrow’s winners.

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Institutional investors in private equity real estate vehicles need to be more realistic over property valuations amid expectations opportunistic fund managers face further “significant” write-downs.

A white paper published by placement agent Probitas Partners insisted limited partners need to take a “realistic view of the value” of their portfolios, saying now was the time to have “serious discussions” with GPs “still carrying portfolios at values significantly in excess of current reality”.

The San Francisco-based firm said many real estate opportunity funds reported only “modest value impairments” in 2008, with material write-downs filtering through in the final quarter of 2008.

However, Probitas warned the write-downs were equivalent of just half those seen in the US public real estate markets, and – when combined with the higher leverage used by opportunistic managers – “there is significant further devaluation to be reflected in opportunistic fund assets as they are marked-to-market to more closely reflect public company values”.

The firm said though there would be an “exceptional” near-term opportunity for investors, particularly third-party capital investors, to refinance or restructure fund assets, provided investors were able to identify assets with sufficient equity to protect and injected capital with a focused team not distracted by legacy issues and operational issues. The US and UK would offer some of the best opportunities, the firm added.

But where deals are already under water, Probitas said, rather than being restructured, the asset would eventually be taken back by lenders and sold in portfolios.

Unveiling its winter real estate report, Real Estate Private Equity Fund Investing: Profound Changes for the Road Ahead, Probitas said bargains would be found in the secondaries market but that investments should be made “strategically and selectively … in surviving and thriving managers”.

Presenting a self-proclaimed sober analysis, the firm stressed one of the key decisions facing LPs as they looked to 2010 was manager selection, warning an LP’s “current, favourite GPs [might] not be around five to 10 years from now”.

“The notion of investing with a fund sponsor as an unchanging, long-term relationship is an unrealistic aspiration, with limited chance of success in the real estate fund market, as people and institutions change over time,” the report said.

The “clear winners” from today’s crisis would be those firms that used the next year to assemble an RTC-era like talent, including accounting, legal and real estate operations professionals, “construct[ed] systems around that talent”, and entered the market “at scale, because the magnitude of the asset flow that has to be restructured or taken back and resold is massive.

“The reward for identifying and investing with these emerging victors of tomorrow is that they will lead the way into the next cycle.

“If the RTC experience is any guide, and we think it is, the next two to three years of working through the commercial real estate asset deleveraging and restructuring will spawn the top firms at the mid-point of the next decade who will capitalise on an unprecedented opportunity for value creation for those investors brave enough and capable of executing before the opportunity is so obvious that it is already past.”

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