

The secondaries market in 2009/2010



The real estate secondary market is approaching critical mass, with 2010 promising attractive opportunities for secondaries investors targeting specific quality funds.

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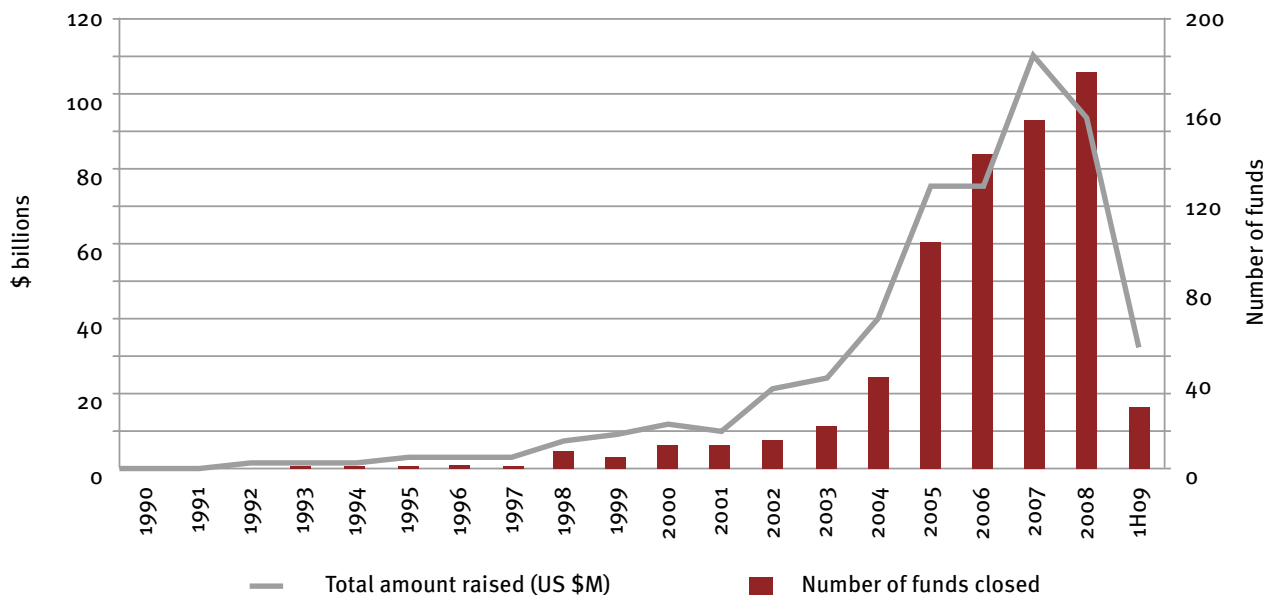
In the private equity arena, the sector of most interest to investors currently is secondaries; it is literally the only sector in all of private equity where fundraising for 2009 exceeds 2008. This is a clear reflection of investors' expectation to purchase fund positions at attractive discounts.

As detailed in the chart on p. 22, the private equity real estate sector, while in existence for over 20 years, only recently experienced a dramatic expansion starting in 2003, a decade after private equity began to grow. In any secondary market, a major driver of activity is the depth of the primary market. The private equity real estate secondary market is just on the verge of achieving critical mass for the first time

in response to perceived buying opportunities created by the current distressed real estate market.

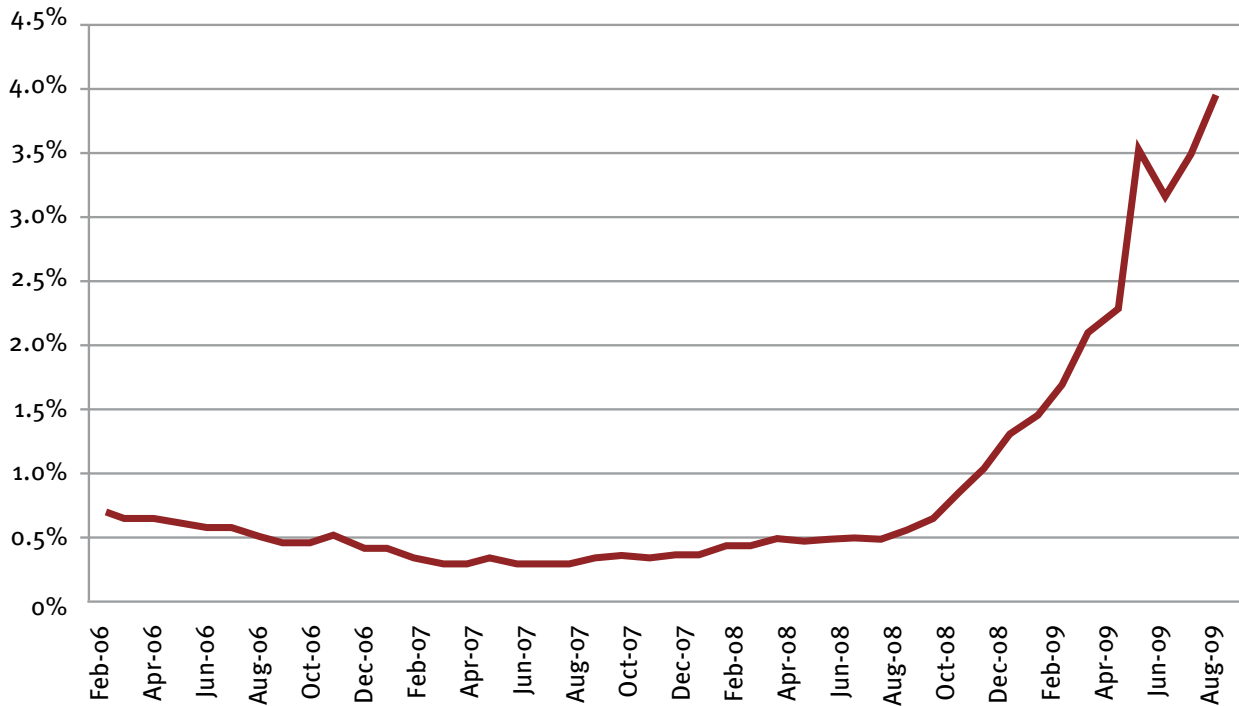
Many market participants expected the vast majority of transaction volume to encompass US-focused funds engaged in value-added and opportunistic investment strategies, but much of the recent market activity has been in core and core-plus strategies where leverage ratios are lower and there is greater perceived visibility regarding the current value. Additionally there is increasing interest in the Western and Northern European markets for opportunity funds due to the fact that these markets have held up and are expected to hold up much better than the US. While the UK market has not fared as well as

Global real estate fundraising 1990-2009



Source: Probitas Partners

Monthly CMBS delinquency rates, 2006-2009



Source: Realpoint LLC

continental Europe, it too is generating a significant amount of interest, primarily due to recent sharp declines and investors' belief that the UK market is now at or near the bottom.

Real estate opportunity funds certainly have suffered their problems in this market cycle due to high purchase prices and high leverage on portfolio assets, especially those acquired in the 2006 to 2008 period. However, core real estate assets generally enjoy longer-term lease contracts that can provide for more durable income even in economic down turns. As a result, stabilised assets and pre-leased assets may have experienced impairments in value, but still remain viable investment opportunities, although with reduced upside potential.

Many limited partners and general partners anticipate that values are likely to continue to soften through the second half of 2010. This is especially concerning in the US where the commercial mortgage-backed securities (CMBS) market, which accommodated aggressive leverage, has hampered the ability of all parties to proactively restructure financing packages to be more appropriate to the current economic environment. As a proxy for problems in the US market, the chart on p. 23 shows the steep increase in CMBS delinquency rates in 2009, with the slight downturn in the July number driven by a technical correction rather than any real improvement. The combination of rising cap rates, leverage most often in the range of 70 percent to 80

percent, a moribund refinancing market and now rising vacancies caused by a declining economy have created a perfect storm. While historically many non-US GPs were envious of their US counterparts' access to cheap and abundant credit courtesy of the CMBS market, this perceived deficiency has proved to be a blessing. The reliance on smaller lending syndicates and a greater proportion of equity in their capital structures has provided non-US GPs a much greater ability to proactively restructure loans and protect their ownership positions.

The buyer landscape

As mentioned, the real estate secondary market is approaching critical mass in terms of dedicated capital for the purchase of secondary fund positions. But it is early and the amount of capital compared to the anticipated flow of opportunities is

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still relatively modest. Compare this situation with the private equity secondary market with as much as \$40 billion of dedicated purchasing power to see how far the real estate secondary

Specialist real estate secondary funds currently in market

Fund	Manager	Target Size (m)	Fund Focus	Website
Aviva Global Real Estate Partners	Aviva Investors	\$500	Global	www.avivainvestors.com
Belveron Partners Fund II	Belveron Real Estate Partners	\$100	US	www.belveronpartners.com
CS Strategic Partners V RE	Credit Suisse	\$450	Global	www.creditsuisse.com
Landmark Real Estate Fund VI	Landmark Partners	\$750	US	www.landmarkpartners.com
Liquid Realty Partners V	Liquid Realty Partners	\$800	US	www.liquidrealty.com
Partners Group Real Estate Secondary Fund	Partners Group	\$500	Global	www.partnersgroup.net
Total		\$3.1 bn		

Source: Probitas Partners

market has to go. That shortfall may create a significant opportunity for buyers with capital to invest over the next two to three years. Many traditional real estate LPs are looking to the secondary market as a way to gain access or greater exposure to favoured general partners. Additionally, several organisations are using the secondary market as a tool to provide exposure to specific vintage years.

Currently, a number of funds are in the market seeking to raise capital for investment into real estate secondary positions:

In the real estate market, however, valuations are still falling and likely to do so for many funds until at least the second half of 2010. This is perpetuating a wide divergence between buyers' and sellers' price expectations akin to what we saw in the private equity secondary market up until just a couple of months ago.

Notably, Aviva Investors and Partners Group are raising first time vehicles dedicated to the sector. Several of the established private equity secondary funds are taking a hard look at establishing dedicated real estate teams and vehicles. In addition, many of the funds of funds focused on real estate plan to devote substantial amounts of their capital in existing or planned vehicles to secondaries.

Major issues in the market

For participants in the real estate secondary market, there are several issues to take note of:

How do you price funds with valuations still falling? There are signs in the private equity market that valuations are firming and discounts are closing. This is largely a combination of sellers becoming more realistic in the face of better valuation data, and buyers no longer fearing the falling knife

after two quarters of stable and in some cases rising valuations. In the real estate market, however, valuations are still falling and likely to do so for many funds until at least the second half of 2010. This is perpetuating a wide divergence between buyers' and sellers' price expectations akin to what we saw in the private equity secondary market up until just a couple of months ago. As a result, funds with assets of questionable quality or focused on tertiary markets will generate limited buyer interest, whereas funds with high quality assets in stable markets will continue to be attractive to secondary investors.

Broad portfolio purchases will be difficult to execute – buyers tend to focus on assets they know well and are reticent to take on the risks associated with assuming a commitment to an unfamiliar GP. Targeted purchases of high quality funds and structured transactions designed to

mitigate risk will dominate closed transactions this year and well into 2010.

Experienced professionals are in short supply – there are few experienced professionals in the market who understand both secondaries and real estate. As market activity begins to expand, the time and ability of experienced professionals to process deal flow could be as much or more of a limiting factor to transaction volumes than capital.

Even with these constraints, there will be attractive opportunities in the real estate secondary market for investors targeting specific quality funds, with more activity likely later in 2010 as the market reaches bottom. Of course, investors who are stressed and need immediate liquidity will ultimately sell before then, creating truly distressed buying opportunities for sophisticated buyers, especially those equipped to handle the post-acquisition issues in order to create even greater value from those positions. □



Today's private equity and real estate secondary markets are dynamic and complex. Navigating the maze of options available to investors requires strategic thinking and thorough planning. Probitas Partners can help every step of the way.

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