Real Estate Institutional Investor Trends for 2017 Survey

Probitas Partners

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probity (prō′bĭ·tē)
n. [from Latin probitas: good, proper, honest.] adherence to the highest principles, ideals and character.

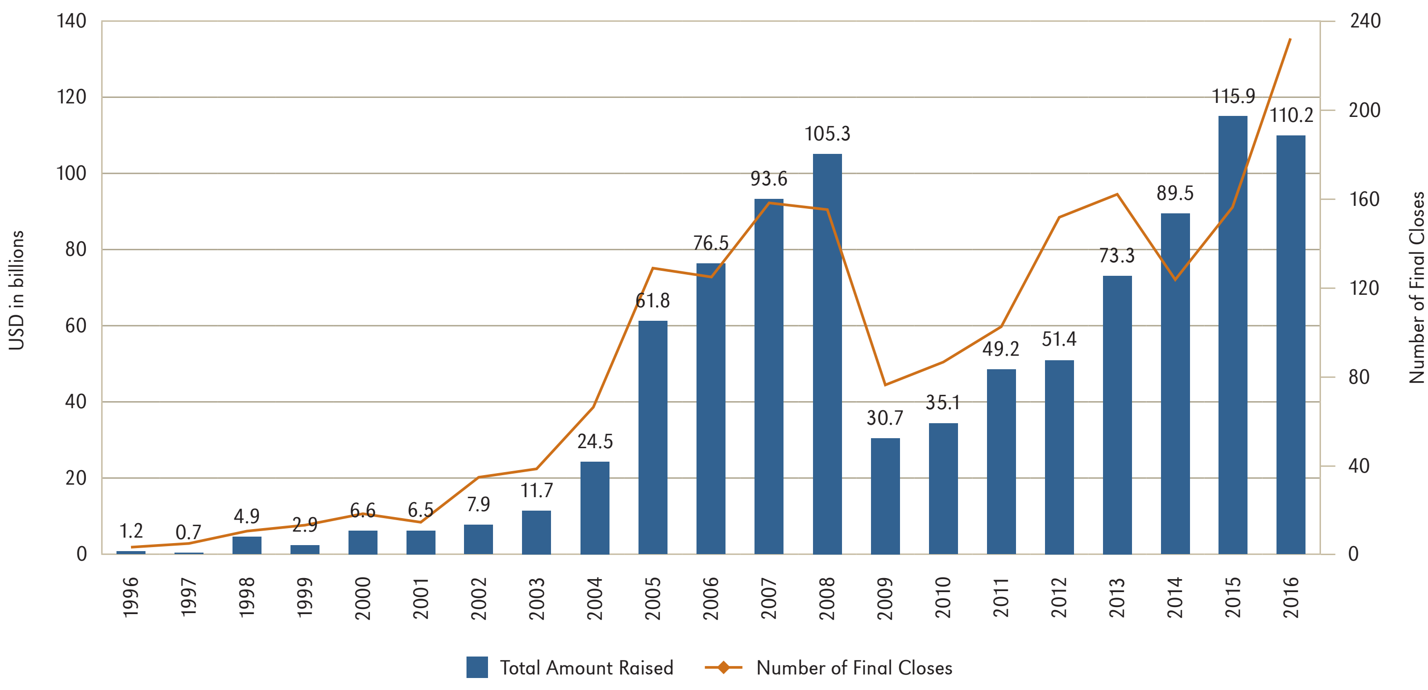
On an ongoing basis, Probitas Partners offers research and investment tools for the alternative investment market to aid its institutional investor and general partner clients. Probitas Partners compiles data from various trade and other sources and then vets and enhances that data via its team's broad knowledge of the market.

The Real Estate Fundraising Environment

- Closed-end fundraising in 2016 slipped by 4% from the all-time peak reached in 2015 (Chart I) as fewer large funds were raised — though the total number of funds with a final close shot up during the year.
- North America regained its spot as the leading geographical focus for global funds in 2016 — though most global funds have large internal allocations to North America. Fundraising for European-focused funds increased strongly during 2016 as well (Chart II).
- Commitments to opportunistic funds continued as the most preferred strategy, though they declined from last year (Charts III). Core and core plus strategies remained muted, but those commitments continue to understate interest in the sector as many institutions targeting those strategies invest directly in properties or through separate accounts. Interest in distressed strategies declined significantly in 2016, while commitments to debt strategies increased significantly.

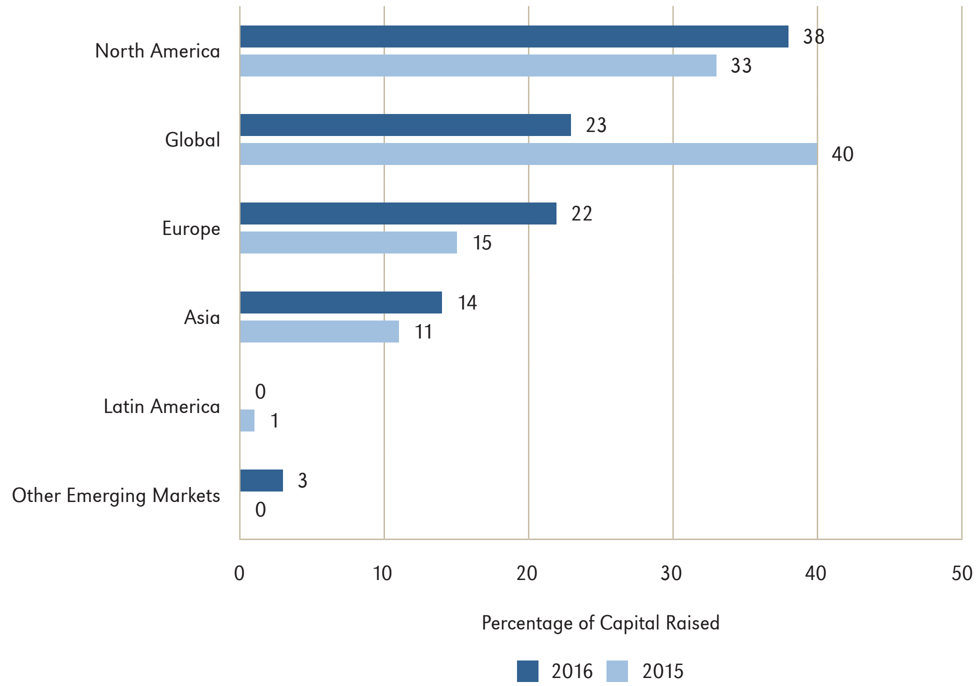
Fundraising in 2016 slipped by 4% from the all-time peak reached in 2015

Chart I Global Real Estate Fundraising 1996–2016



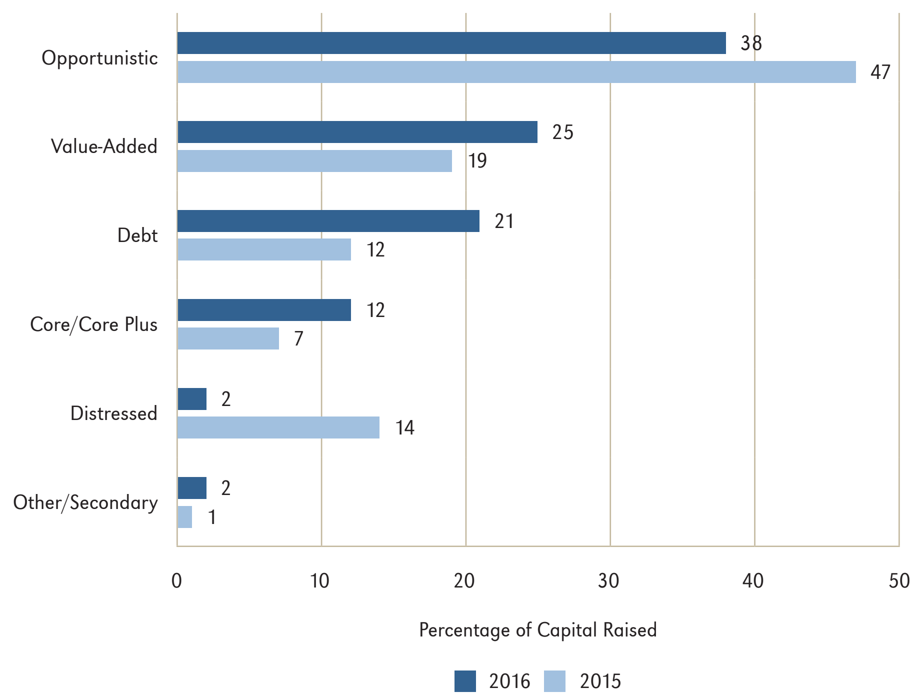
Source: Probitas Partners; PREQIN; PERE; IREI, as of February 2017

Chart II Global Real Estate Fundraising by Geography
(in terms of capital raised, USD)



Source: Probitas Partners

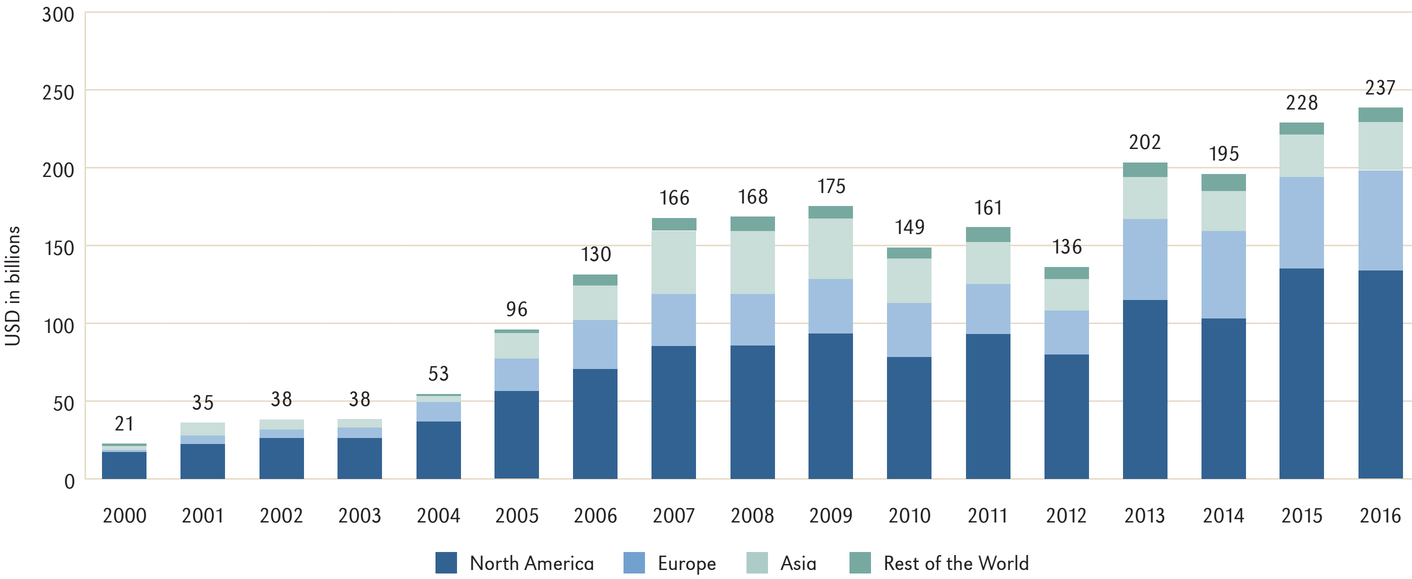
Chart III Global Real Estate Fundraising by Strategy
(in terms of capital raised, USD)



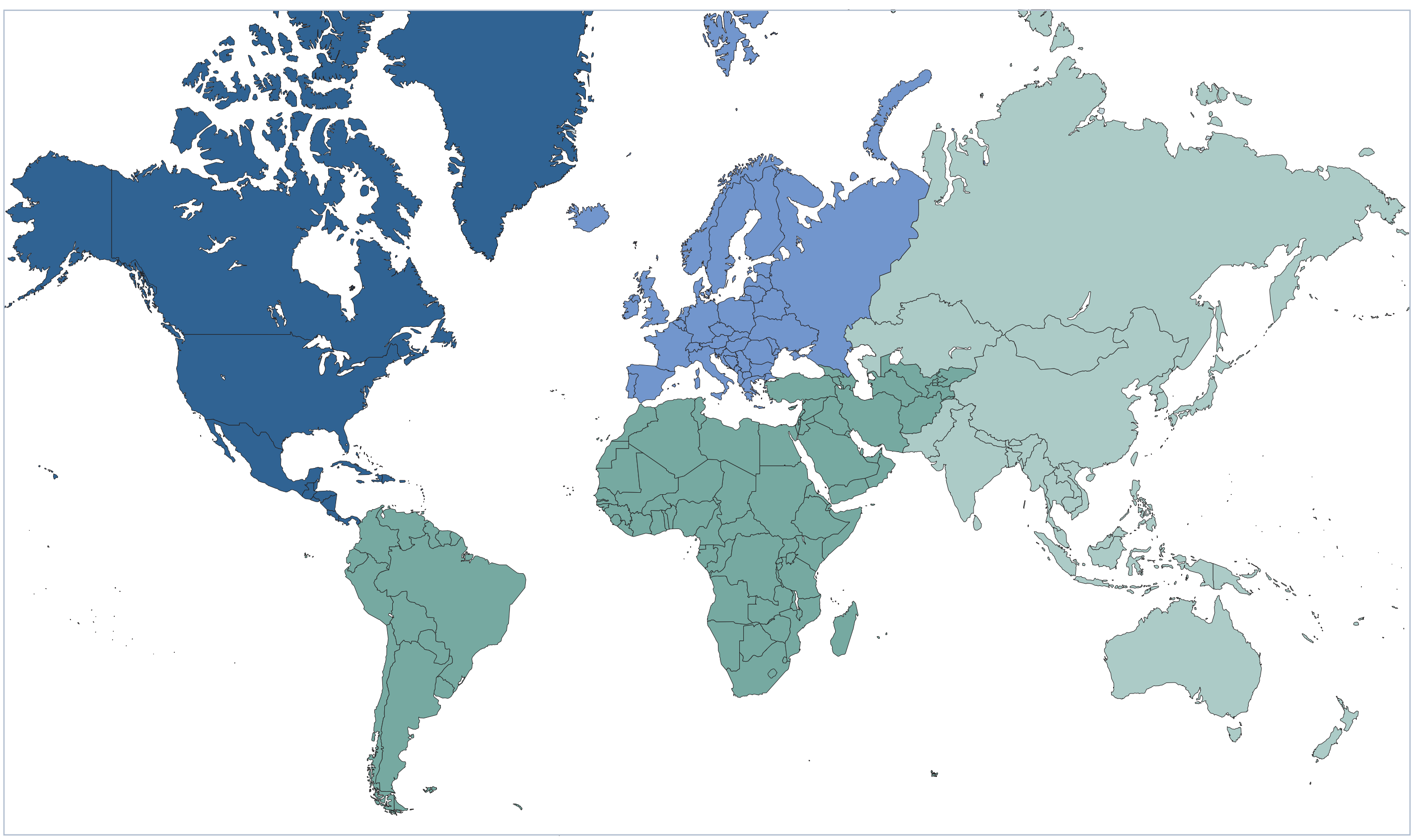
Source: Probitas Partners

- As a corollary to fundraising, Probitas Partners also tracks the amount of dry powder (or uninvested commitments) in the market. Dry powder reached a new year-end high in 2016, driven by commitments to North America (Chart IV) as new commitments substantially exceeded investments made during the year.

Chart IV Real Estate Dry Powder by Geography



Source: PREQIN, as of February 2017



Real Estate Institutional Investor Survey

In February 2017, Probitas Partners conducted its latest online survey of institutional investors to determine their perspectives on investing in the real estate market and the trends driving this market. Senior real estate investment staff globally responded to the survey, representing such institutions as consultants, insurance companies and banks, pension plans, endowments and foundations, and family offices.

Overview of Survey Findings

The following summarizes the top-line findings from the survey:

- ***Interest in closed-end real estate funds remains strong:*** Though fundraising in 2016 declined slightly from the previous year, interest remains strong in the developed markets, and investors plan to keep targeting the sector.
- ***Investors are increasingly concerned that we are reaching a cyclical market peak:*** 76% of respondents cite this as their major fear for this year.
- ***Over the last two years there has been a continued shift in interest towards value-added and opportunistic funds:*** The flood of money going into core assets has driven down returns and caused investors to shift more attention to these strategies in search of enhanced returns.
- ***. . . But investors are split on core:*** There is still interest in core investments, especially among large investors with the staff and experience to invest directly. However, a growing number of fund investors say that they do not invest in core at all.
- ***Interest in debt funds has been volatile:*** Debt-focused funds surged to an all-time fundraising high in 2013, fell in 2014 and 2015, and rose again in 2016. Looking ahead to 2017, interest seems to have moderated again.
- ***For most investors, North America remains the primary geographic focus:*** North America has always been the biggest real estate market for institutional investors, and it remains so. However, there is also increasing interest in Europe.
- ***Interest in warehouse/logistics surged this year:*** As far as industry sectors, it overtook the standard market stalwarts of office, multi-family and retail to reach the number one position.
- ***Interest in emerging markets remains muted:*** Interest in emerging markets has always been volatile, and this year it remains weak. There are continuing concerns that political and economic risks — especially in the key larger markets — pose significant risk; investors are less convinced that the longer-term, high-growth story of emerging markets necessarily leads to outsized real estate returns over the shorter term.

Investors are increasingly concerned that we are reaching a cyclical market peak

Profile of Respondents

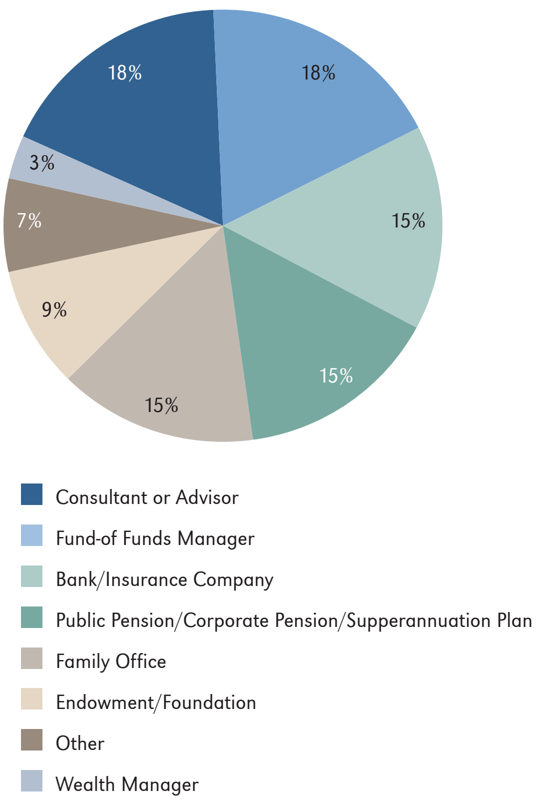
- Respondents by investor type were diverse (Chart V) with strong representation from consultants, funds-of-funds managers, banks and insurance companies, pension plans, family offices and endowments/foundations. "Other" respondents included a church pension, a healthcare system, and an outsourced CIO.

- Since the United States has a long history of institutions investing in real estate through closed-end funds and is the most active market, it is not surprising that 62% of the respondents to the survey were from the United States (Chart VI). There were also a significant number of participants from Europe and Asia.

62% of the respondents to the survey were from the United States

Chart V Respondents Categorized by Investor Type

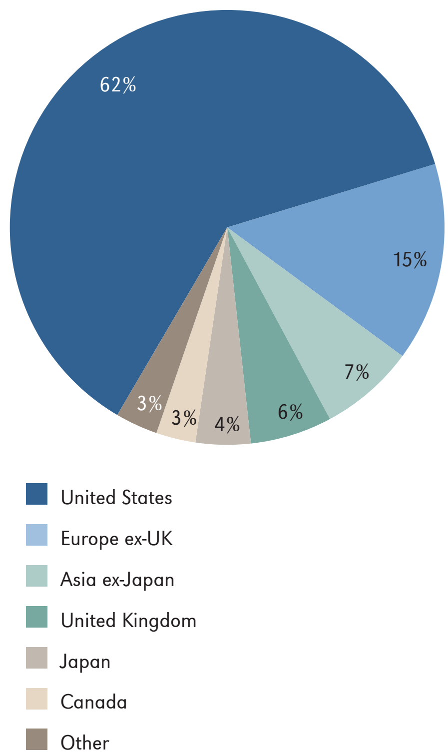
I represent a:



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

Chart VI Respondents Categorized by Firm Headquarters

My firm is headquartered:



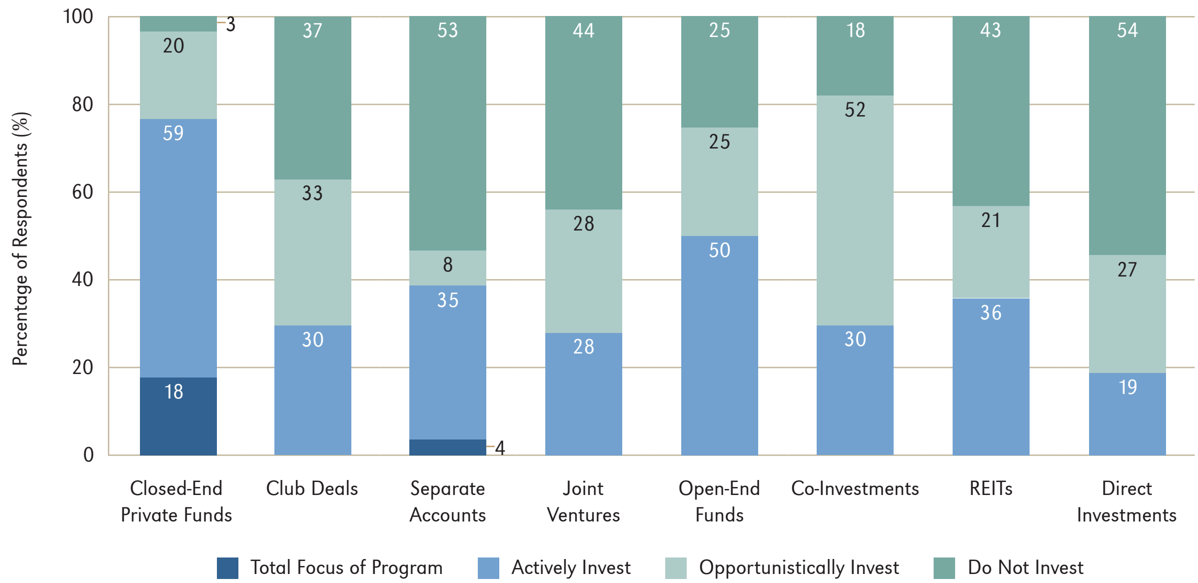
Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

- 97% of respondents either actively or opportunistically invest in closed-end private funds (the largest amount for any sector) and, for 18% of respondents, it is the exclusive focus of their program (Chart VII). Interest in other structures are scattered, though 82% of respondents either actively or opportunistically targeted co-investments.

- A majority of respondents did not invest in either separate accounts or direct investments.

Chart VII Real Estate Investment Structures

I invest via:



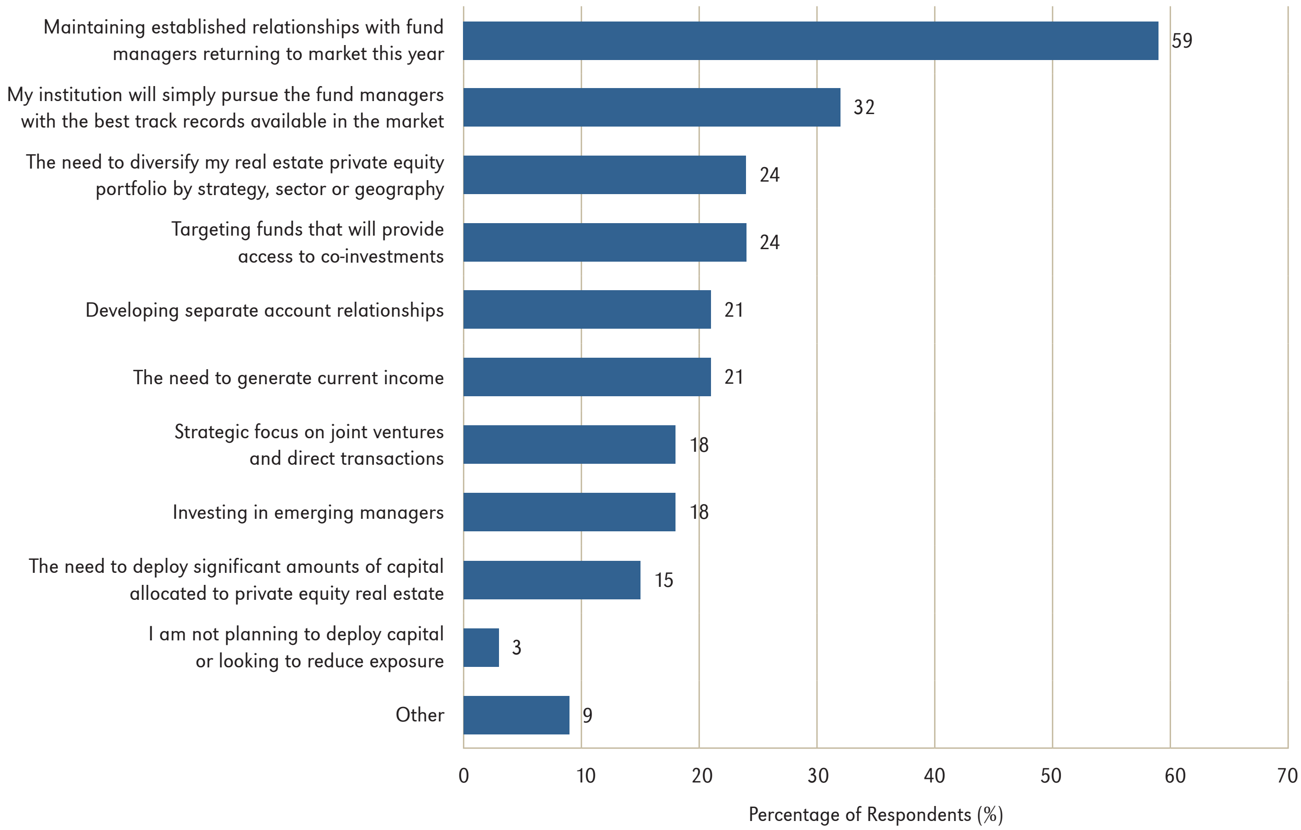
Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

97% of respondents either actively or opportunistically invest in closed-end private funds

- Maintaining established relationships with fund managers jumped significantly as the driving force behind investors' strategies, up from 38% last year to 59% this year (Chart VIII). Simply pursuing the fund managers in the market with the best track record fell out of first place, as the number of respondents citing that strategy dropped from 50% last year to 32% this year. In a very robust fundraising environment, investors are looking to defend their access to preferred managers.

Chart VIII Drivers of Investment Focus

My real estate investment focus over the next year will be driven by (choose no more than three):

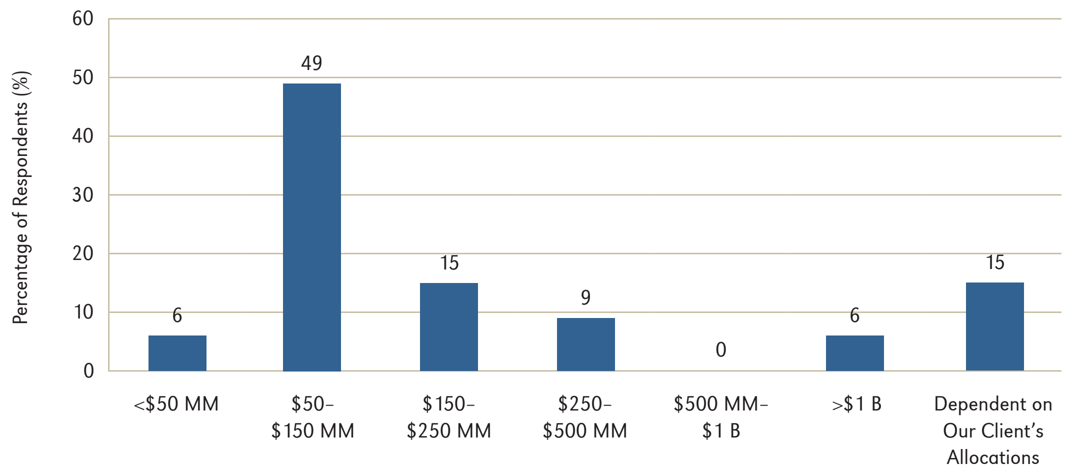


Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

- 55% of the respondents to the survey are targeting commitments of $150 million or less to real estate over the next 12 months (Chart IX). However, a number of investors expecting to deploy much larger amounts, responded as well.
- The average size of individual commitments varied considerably (Chart X), but notably 21% of respondents looked to make individual commitments of $100 million or more.

Chart IX Real Estate Allocations

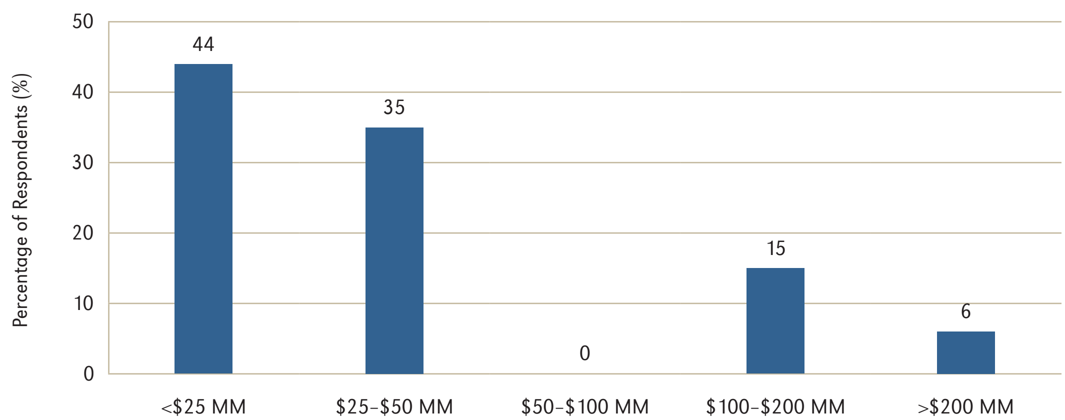
Over the next year, we are looking to commit across all areas of real estate (in USD):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

Chart X Average Size of Investment

Over the next year, I expect my institution's average investment size in real estate investments to be (in USD):

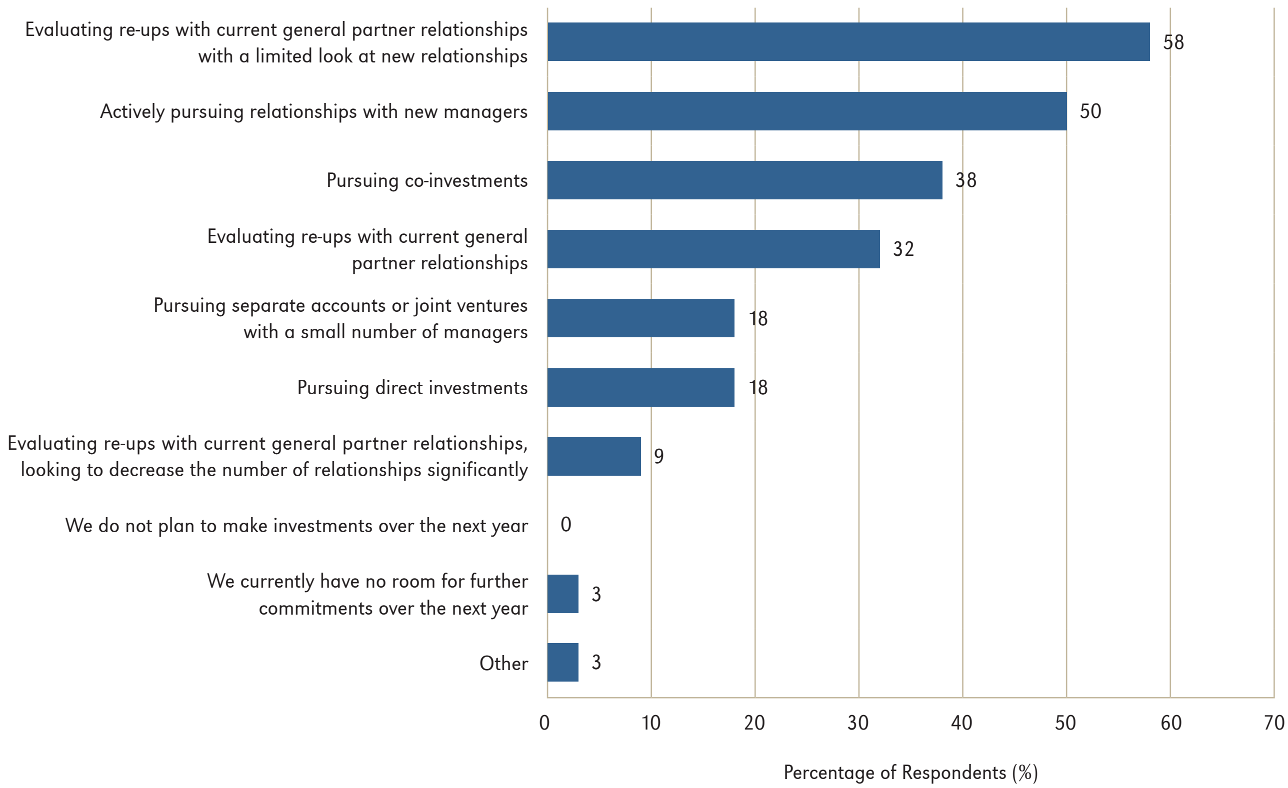


Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

- In 2016, 44% of respondents were focused on re-ups while also taking a limited look at new fund manager relationships — a response that increased significantly to 58% this year (Chart XI). 38% of respondents were also focused on co-investments while 18% were pursuing direct investments.

Chart XI Private Equity Real Estate Focus

Over the next year we would expect our primary private equity real estate focus to be (choose no more than three):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

58% of respondents were focused on re-ups while also taking a limited look at new fund manager relationships

Sectors of Interest

- Over the last three years there has been a shift away from core investment strategies, at least in closed-end fund format. In 2015, 22% of respondents stated that core strategies were the total focus of their program, a number that fell to 14% in 2016 and to 4% this year (Chart XII). This year, 32% of respondents stated that they did not invest in core strategies at all.

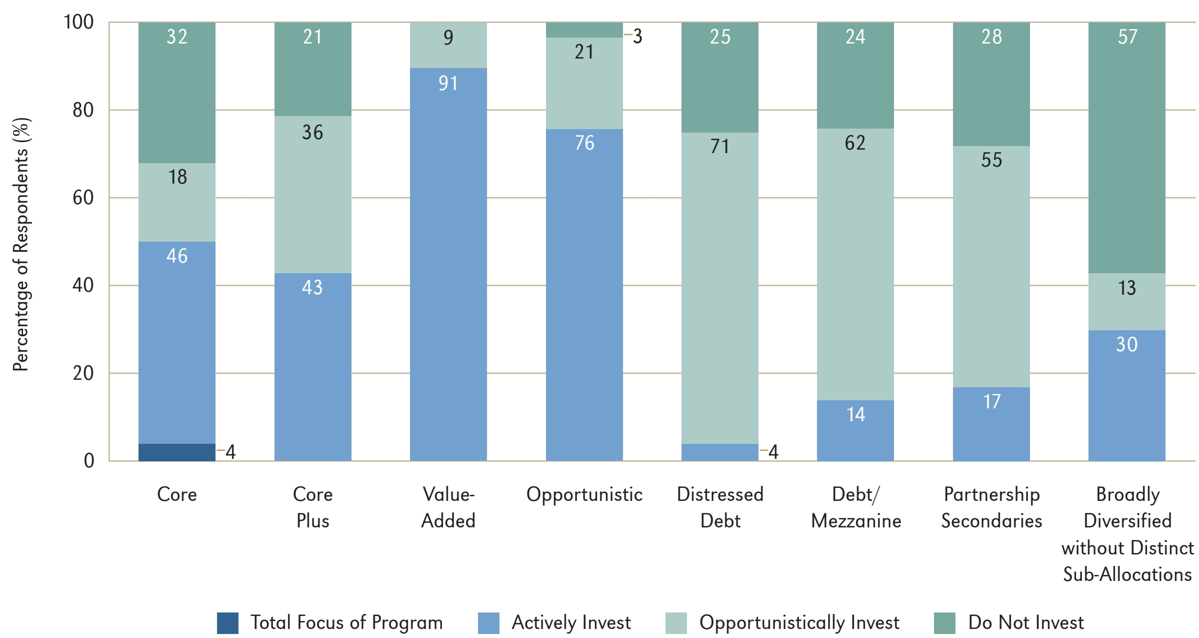
- On the other hand, all respondents either actively or opportunistically invested in value-added funds, the only sector where that was the case. Interest in opportunistic funds remained steady.

- Interest in debt funds has been volatile, and this year saw a steep decline. In 2016, 29% of respondents said that debt was either the total focus of their program or that they actively invested in debt, while this year only 14% of respondents felt that way.

- Distressed debt is not a large focus of investors this year, though certain distressed debt transactions are pursued by opportunistic funds.

Chart XII Real Estate Investment Strategies

As far as risk/return strategies for funds or properties, we focus on:



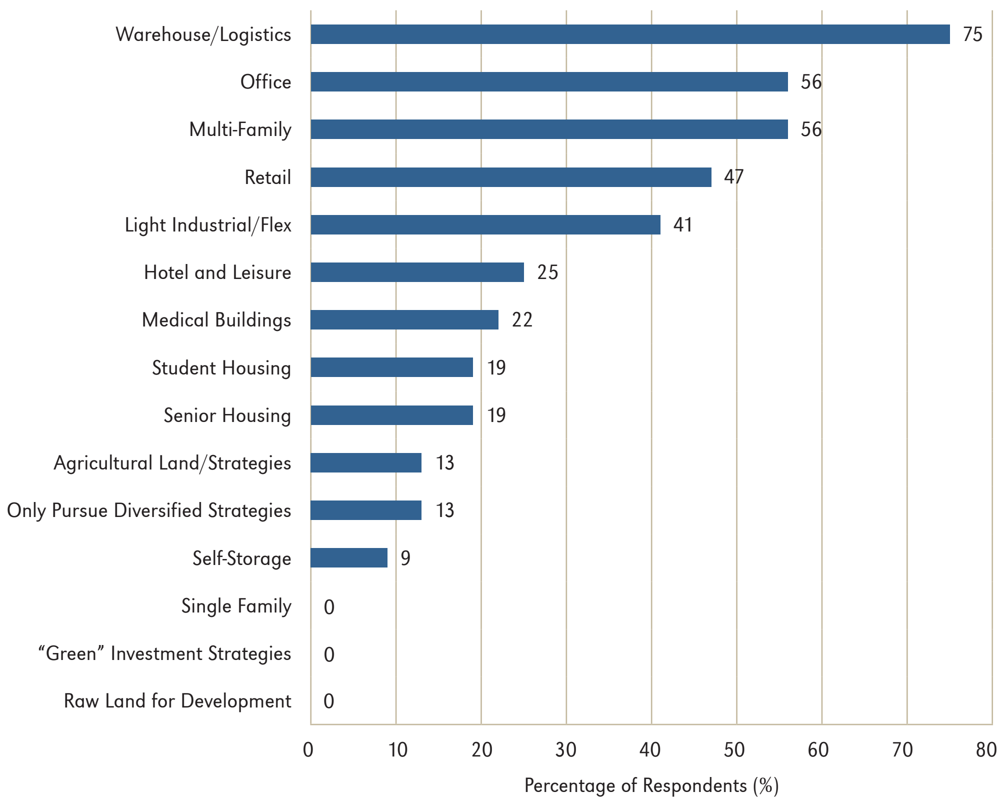
Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

- Interest in the warehouse/logistics sector surged to 75% this year from 45% last year, outpacing, for the first time, the more firmly established office, multi-family and retail sectors (Chart XIII). In part this was due to the fact that Non-North American respondents were much less focused on multi-family (39%) and retail (39%) than were North American respondents.

- There was no interest in green, single family or raw land investments by any respondents.

Chart XIII Real Estate Sector Preferences

For the various industry sectors or sub-sectors of real estate globally, I am most interested in (choose no more than five):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

- To provide a longer-term perspective, Table I compares the top five sectors of interest in this year's survey to our 2007 survey taken just before the Great Financial Crisis ("GFC"). The 2017 survey included more niche strategies as options and allowed respondents to choose more areas of focus to compensate for those additions.

- Even with those caveats, there is a marked difference in responses. The warehouse/logistics sector (which was not included as an option in the 2007 survey and also did not attract any write-in votes) soared to be clearly the leading sector in 2017. Hotel and leisure, which was ranked in fifth place in 2007, placed sixth in 2017, but with much stronger support, with 25% of investors targeting it.

Table I Institutional Investors Focus of Attention Among Real Estate Sectors
Top Five Responses

2007		2017	
Sector	**% Targeting**	**Sector**	**% Targeting**
Office	27%	Warehouse/Logistics	75%
Multi-Family	27%	Office	56%
Industrial	23%	Multi-Family	56%
Retail	14%	Retail	47%
Hotel and Leisure	5%	Light Industrial/Flex	41%

Source: Probitas Partners' Real Estate Institutional Investor Trends Survey, 2007 and 2017

Interest in the warehouse/logistics sector surged to 75% this year from 45% last year

- Real estate debt funds have been a growing sector of the market since the GFC stressed traditional debt sources. However, over the last three years, annual fundraising totals for the sector have been volatile, with 2016 being an up year.

- In the current market, mezzanine has been the largest sector of interest within debt (Chart XIV), though there is significant interest in senior debt and distressed/stressed debt as well.

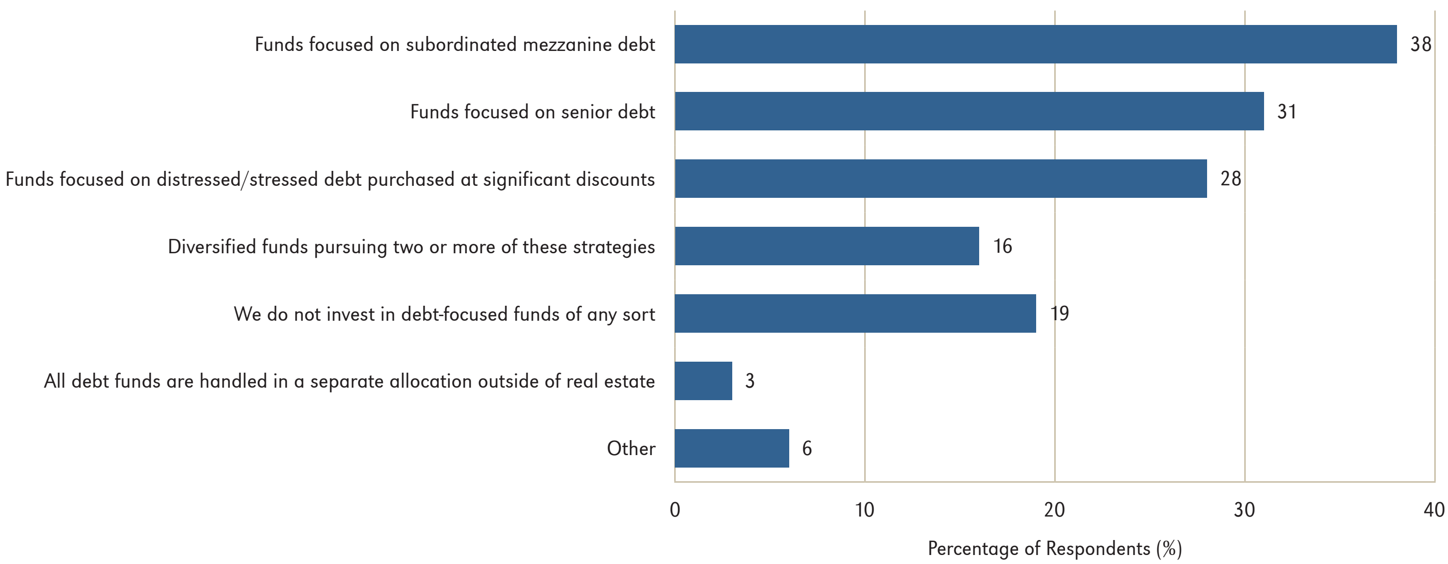
- 19% of respondents stated that they do not invest in real estate debt at all, though Non-North American investors were even less interested, with 40% declaring that they do not invest in real estate debt.

- Many investors feel that fund managers who actively operate properties have an advantage over managers who focus on allocating capital to local managers who will operate a property. For the first time in this year's survey, none of the respondents preferred allocators (Chart XV), with investors split between those who preferred operators and those who simply focused on historical track record.

- Respondents from outside of North America were more focused on historical track record (64%) as the most important attribute (Chart XVI); the remainder preferred operator orientations.

Chart XIV Real Estate/Debt/Mezzanine Funds

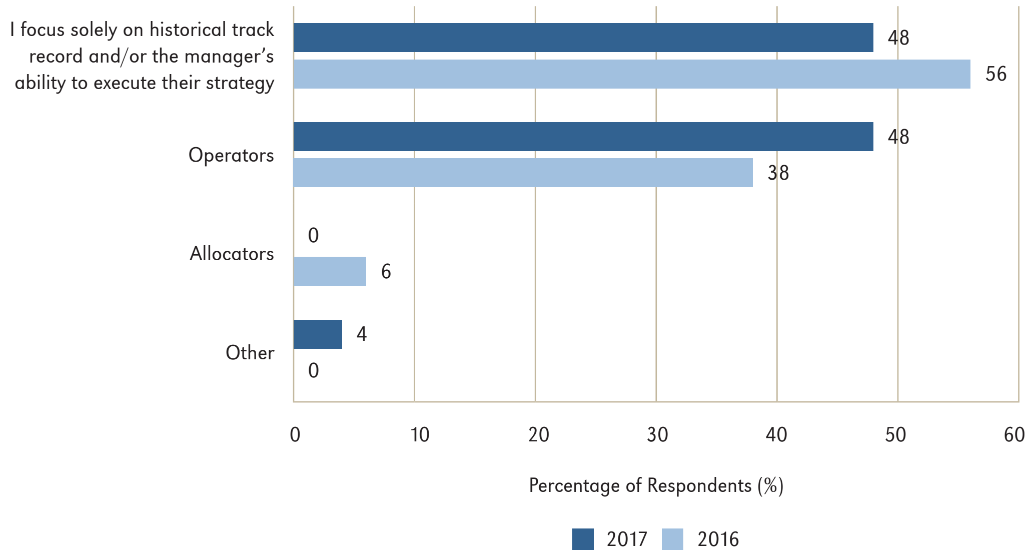
As far as real estate/debt/mezzanine focused funds are concerned, we are interested in (choose all that apply):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

Chart XV Manager Investment Style

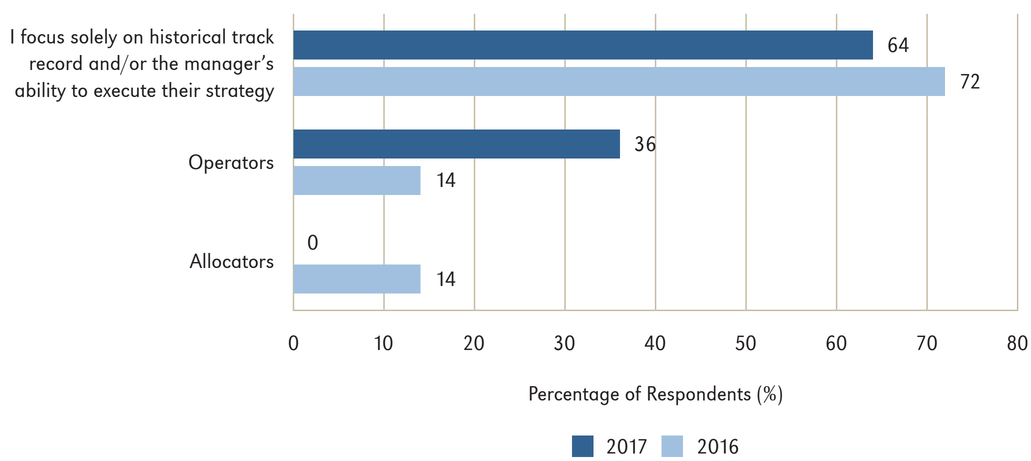
As far as manager investment style, I am more focused on:



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey and 2016 Survey

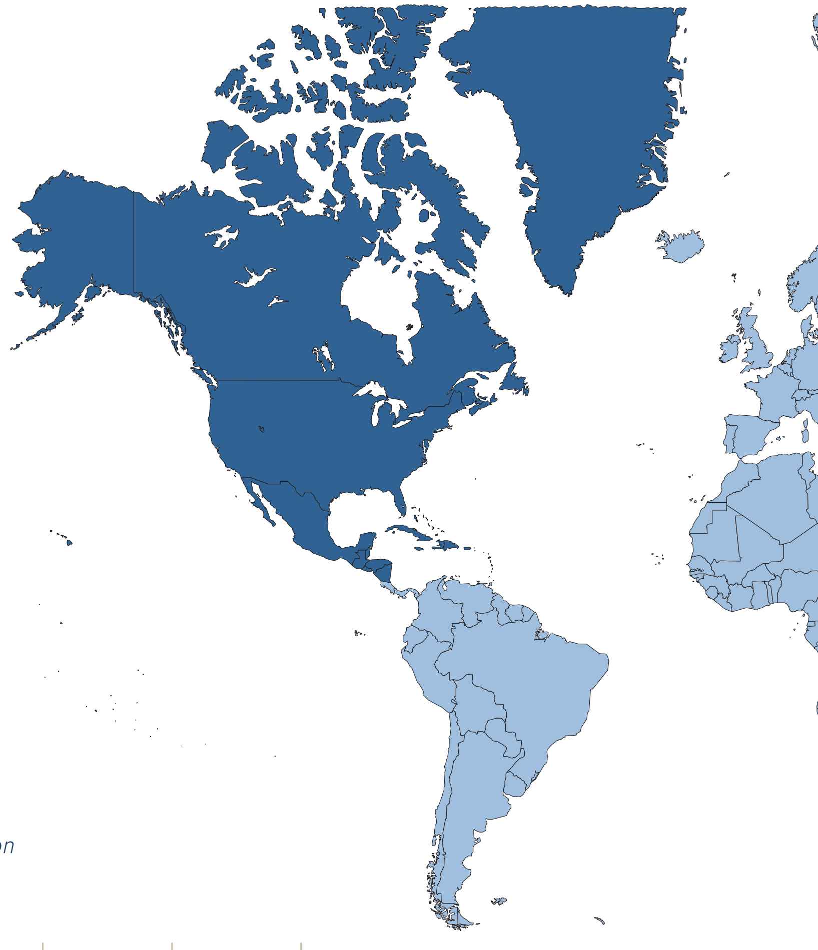
Chart XVI Manager Investment Style — Non-North American Respondents

As far as manager investment style, I am more focused on:



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey and 2016 Survey

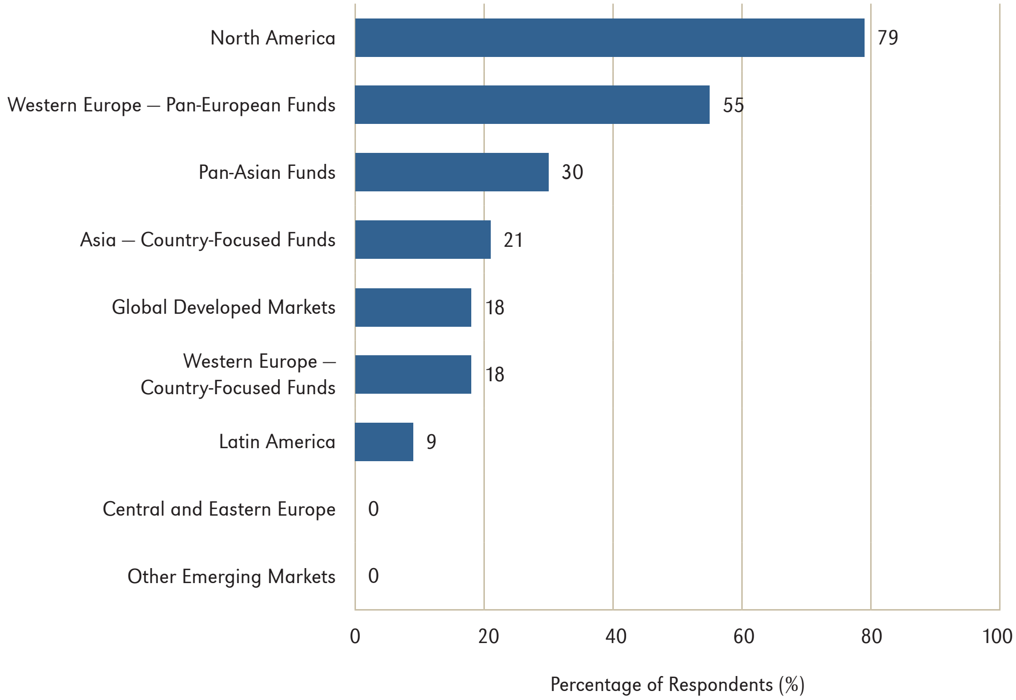
Geographies of Interest



- As it has in all Probitas Partners' past surveys, North America dominated investor geographic preference, increasing from 69% last year to 79% this year (Chart XVII). This is driven by the perceived risk/return trade-off between North America and other regions. It is also impacted by the fact that many investors who responded to the survey were from North America.
- Interest in Pan-European funds also increased, moving from 44% last year to 55% this year.
- The only other sector to attract the interest of more than 25% of the respondents was Pan-Asian funds.
- There are, however, large differences between the interests of North American respondents and the rest of the world (Chart XVIII). North Americans are more focused on both their home market and Pan-European funds, while Non-North Americans are driving interest in Asian country-focused funds and Latin American funds.

Chart XVII Geographic Focus

For the major geographic sectors of real estate, I am mainly focused on (choose no more than three):

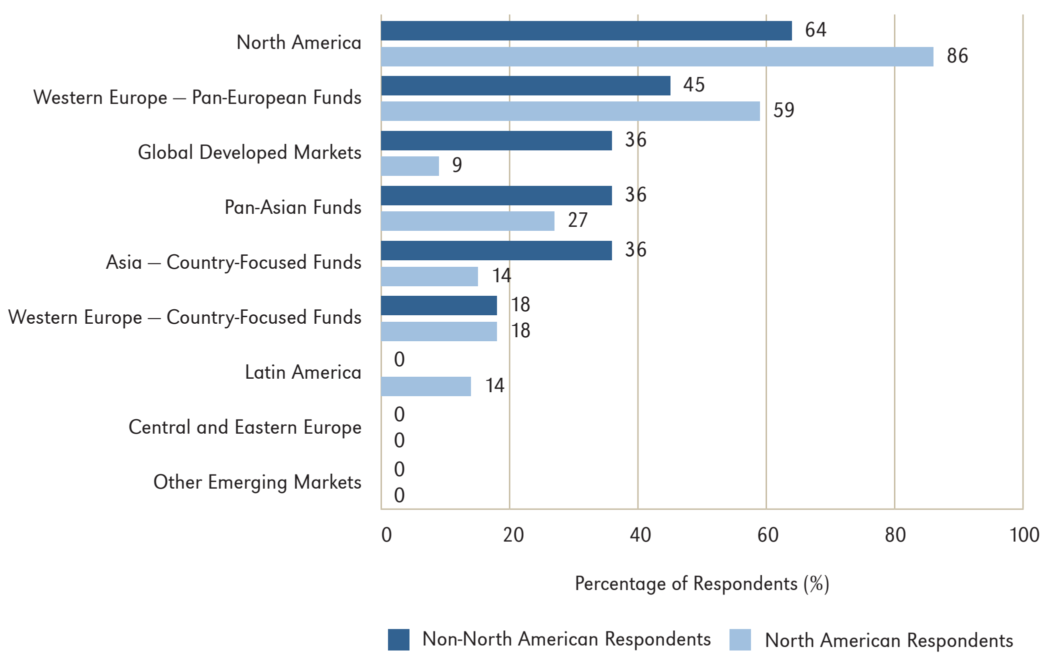


Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

North America dominated investor geographic preference, increasing from 69% last year to 79% this year

Chart XVIII Geographic Focus (North Americans Vs. Non-North Americans)

For the major geographic sectors of real estate, I am mainly focused on (choose no more than three):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

- Germany and the United Kingdom were the clear market leaders of interest when looking at responses from all investors (Chart XIX). However, a more detailed look at the results shows a geographic split — 50% of North American respondents found the United Kingdom attractive while only 36% of investors outside of North America were targeting the United Kingdom, a likely reaction to the Brexit vote.

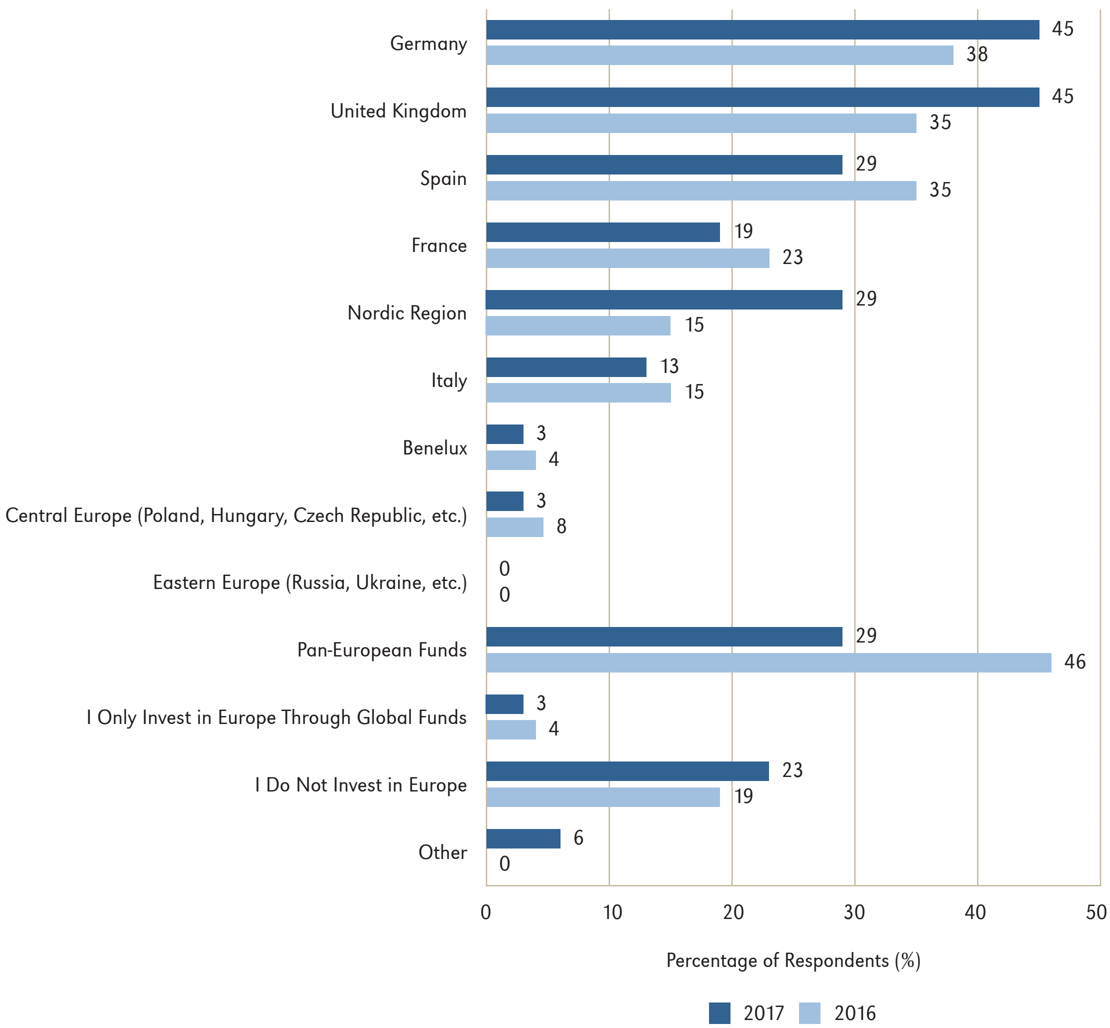
- As far as overall responses, the largest decline in interest hit Pan-European funds — last year's market leader. Interest fell from 46% to 29%, with this decline driven by a fall-off in interest from Non-North American investors.

- The other big change from last year was a surge in interest in the Nordic region, with interest nearly doubling. No respondent found Eastern Europe to be attractive, as it has been for the last two years.

- There was a slight uptick this year in investors who did not plan to invest in Europe at all, increasing to 23% from 19% last year.

Chart XIX Most Attractive Markets in Europe

For Europe, I find the most attractive markets to be (choose no more than three):

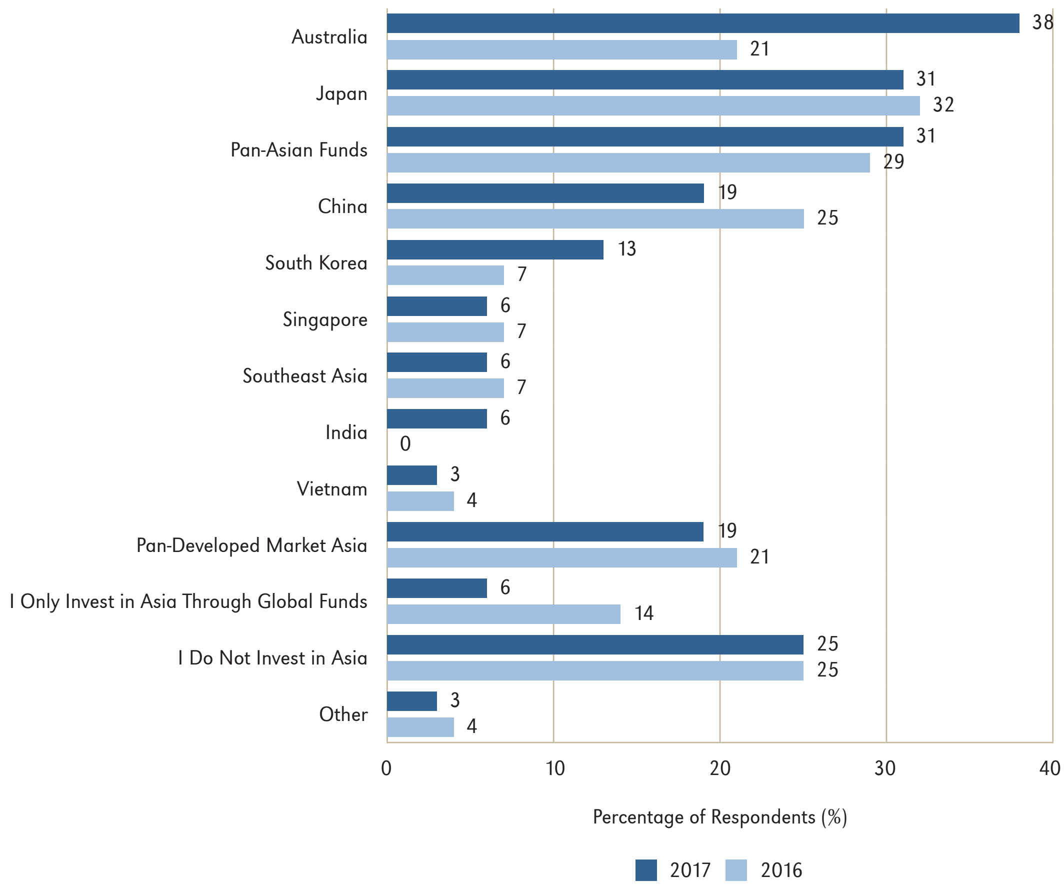


Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey and 2016 Survey

- Australian-focused funds became the leading sector of interest this year in Asia (Chart XX), with interest in Japanese and Pan-Asian funds following closely.
- China-focused funds (which are still the market leader in the private equity sector) continued to decline and fell from 36% three years ago to 19% this year.
- For North American investors, Pan-Asian funds were the leading sector of interest.

Chart XX Most Attractive Asian Markets

For Asia, I find the most attractive markets to be (choose no more than three):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey and 2016 Survey

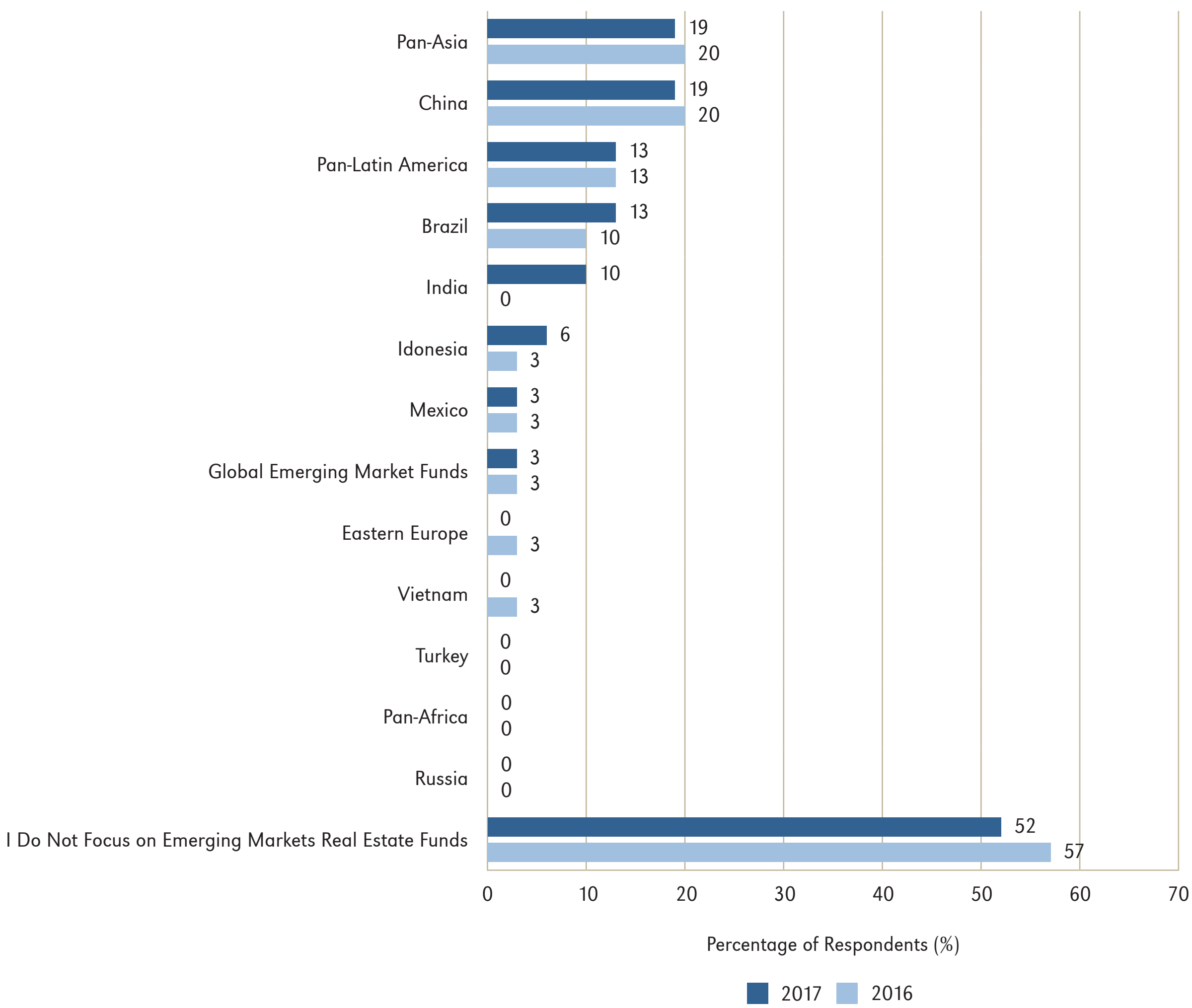
The largest decline in interest hit Pan-European funds — last year's market leader. Interest fell from 46% to 29%

Emerging Markets

- As far as emerging markets in general, the leading response at 52% was that investors were not focused on the sector at all (Chart XXI). Though that response was down slightly from 57% last year, that is still up sharply from 42% of respondents who answered that way two years ago.
- China-focused and Pan-Asian funds were the geographies of strongest interest, with 19% of respondents selecting both of those.
- Interest in smaller niche markets was extremely weak, with no interest in Eastern European, Pan-African, Russian, Turkish and Vietnamese funds.
- India was a bright spot, with 10% of respondents targeting it, as opposed to none last year.

Chart XXI Most Attractive Emerging Markets

For emerging markets, I am targeting (choose no more than three):



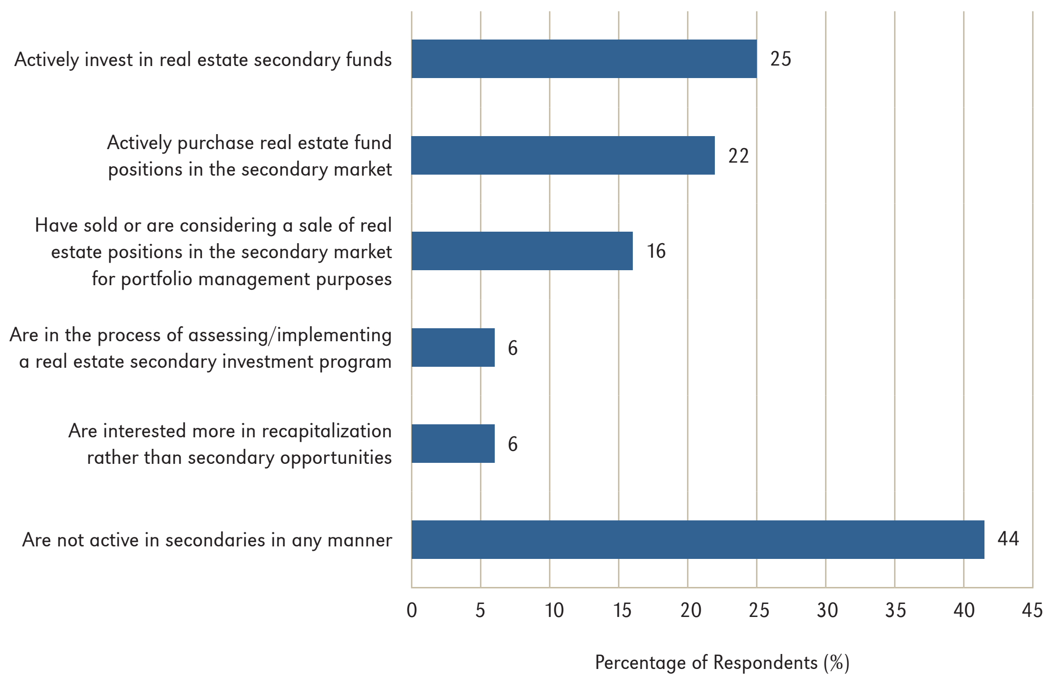
Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey and 2015 Survey

The Secondary Market

- The secondary market for closed-end real estate funds is very young compared to the more established private equity market, but it is beginning to grow. Though 44% of investors said that they were not active in secondaries at all (Chart XXII), the number of investors who say that they invest in specialist secondary funds has more than tripled over the last two years, moving from 7% to 25%.

Chart XXII Secondary Market Investments

In the private equity real estate secondary market, we (check all that apply):

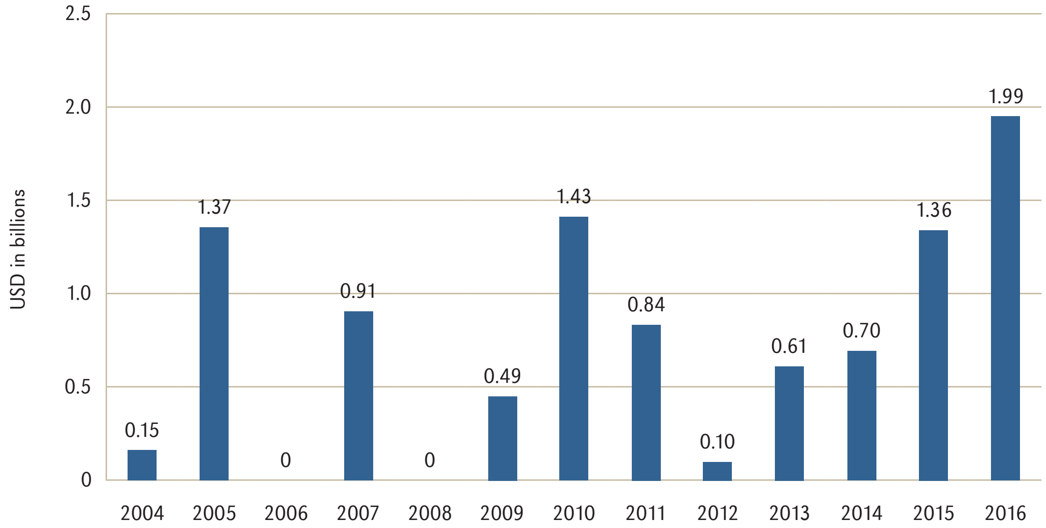


Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

- This interest is reflected in the fundraising numbers for specialist secondary funds detailed in Chart XXIII, with the totals for 2016 reaching a new peak. (Note that no money was raised for specialist secondary funds in 2006 or 2008.)

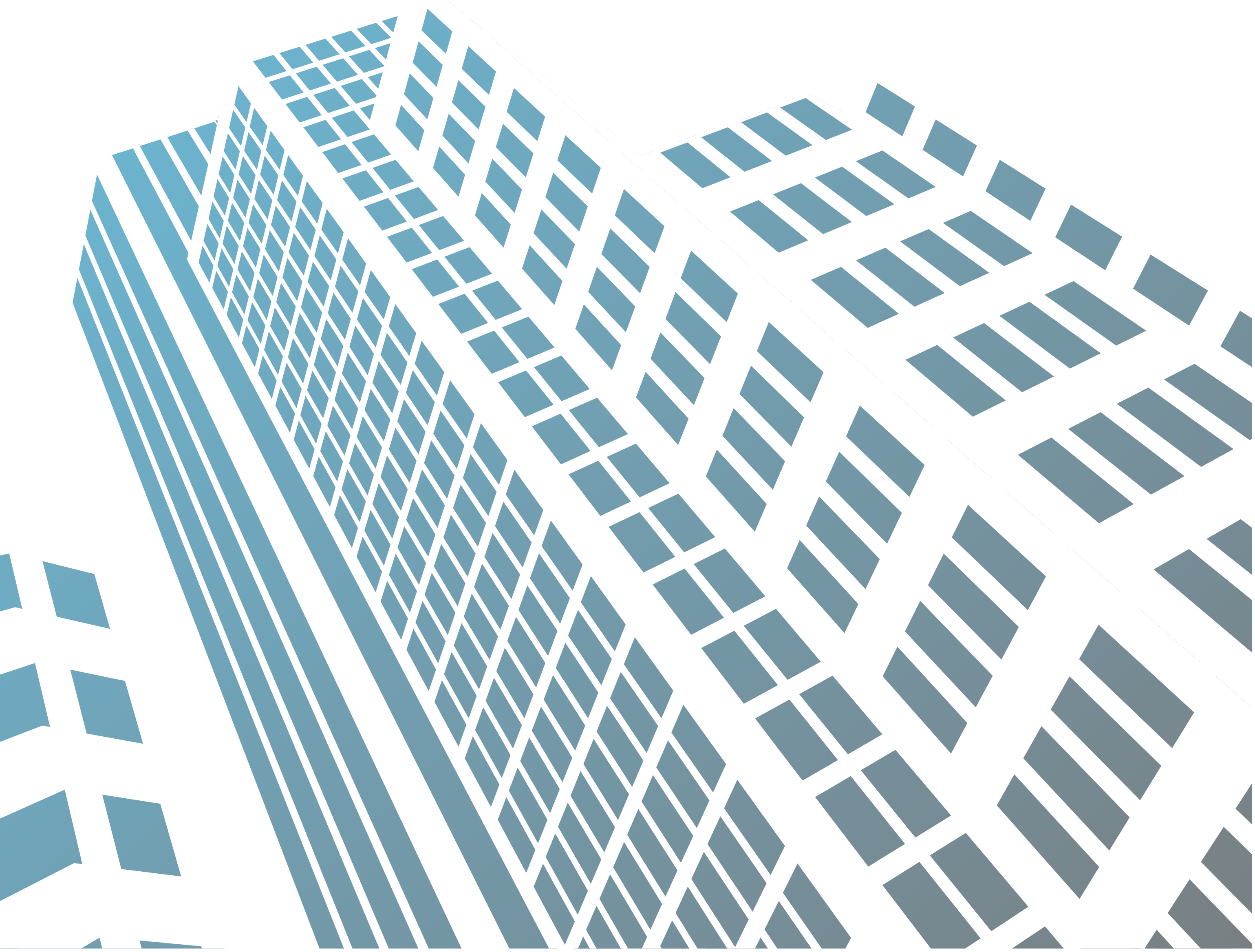
- Fundraising totals are shown only for specialized secondary funds that are completely focused on the secondary market. As noted in Chart XXII, several investors purchase positions directly in the secondary market without going through an intermediary, so the capital targeting secondary purchases is understated.

Chart XXIII Specialist Secondary Fundraising



Source: Probitas Partners

The number of investors who say that they invest in specialist secondary funds has more than tripled over the last two years, moving from 7% to 25%

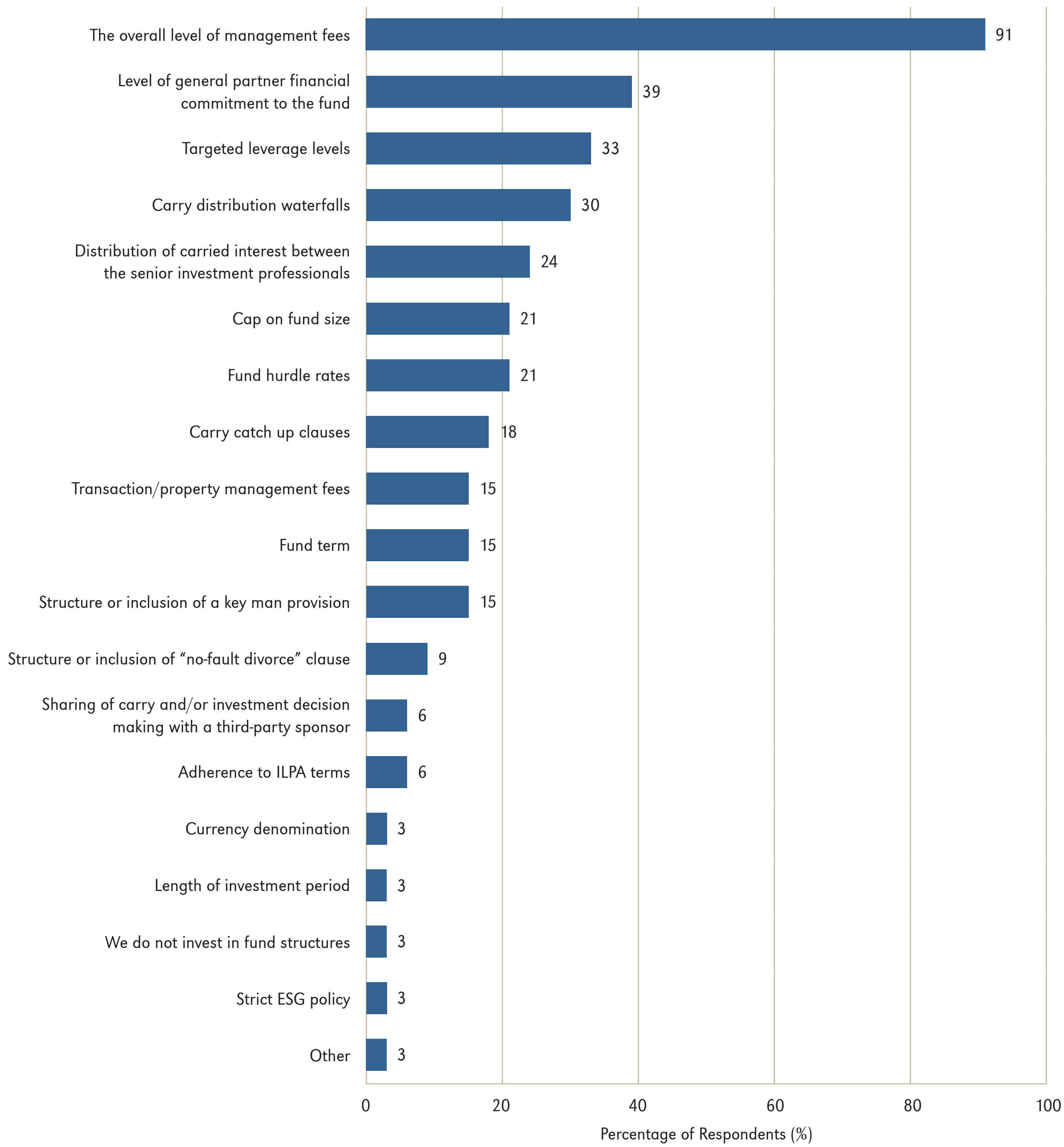


Key Terms and Emerging Managers

- The level of management fees has been the top focus of investors in all Probitas Partners' previous surveys. This year that concern soared to 91%, up from 63% last year (Chart XXIV). Non-North American investors felt even more strongly about fees, with 100% of them citing it as an issue. No other issue approached that level of importance.

Chart XXIV Issues Regarding Terms or Fund Structure

The terms or fund structure we most care about are (choose no more than three):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

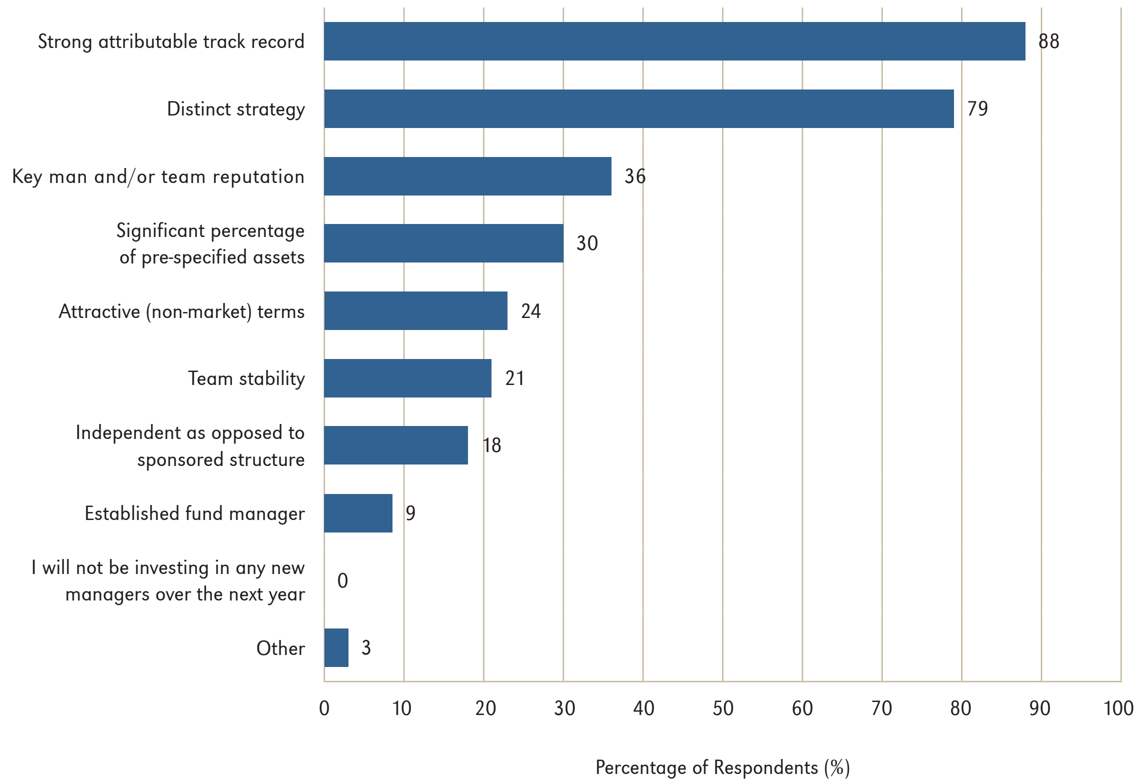
- As noted in Chart XXIV, having strict ESG policies in place has been an issue gathering increasing interest in the press and more interest among private equity investors, but only 3% of respondents said that it was an important issue for them in real estate investing.

- Consistent with last year, investors are most focused on a strong attributable track record and a distinct, repeatable strategy when looking at new managers (Chart XXV), though other factors have an impact.

- None of the respondents rejected investing in new managers over the coming year, so this is an area of importance for them.

Chart XXV Key Characteristics of New Fund Managers

The key characteristics required for me to consider an investment in a new manager (choose no more than three):



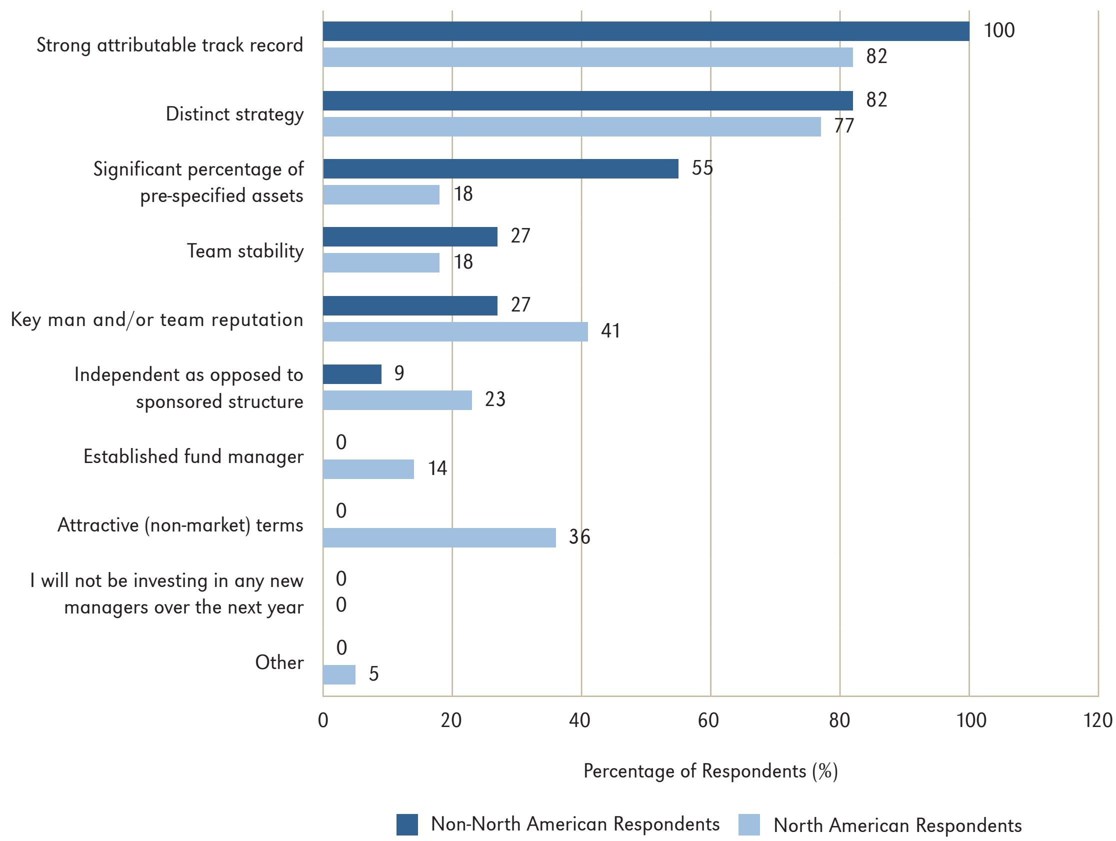
Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

Investors are most focused on a strong attributable track record and a distinct, repeatable strategy

- There are some differences geographically: Non-North American investors are much more interested in pre-specified assets, with 55% of them targeting this characteristic compared to 18% for North American investors. On the other hand, North Americans are more focused on attractive non-market terms, with 36% of them targeting that characteristic, while none of the respondents from the rest of the world did (Chart XXVI).

Chart XXVI Key Characteristics of New Fund Managers

The key characteristics required for me to consider an investment in a new manager (choose no more than three):



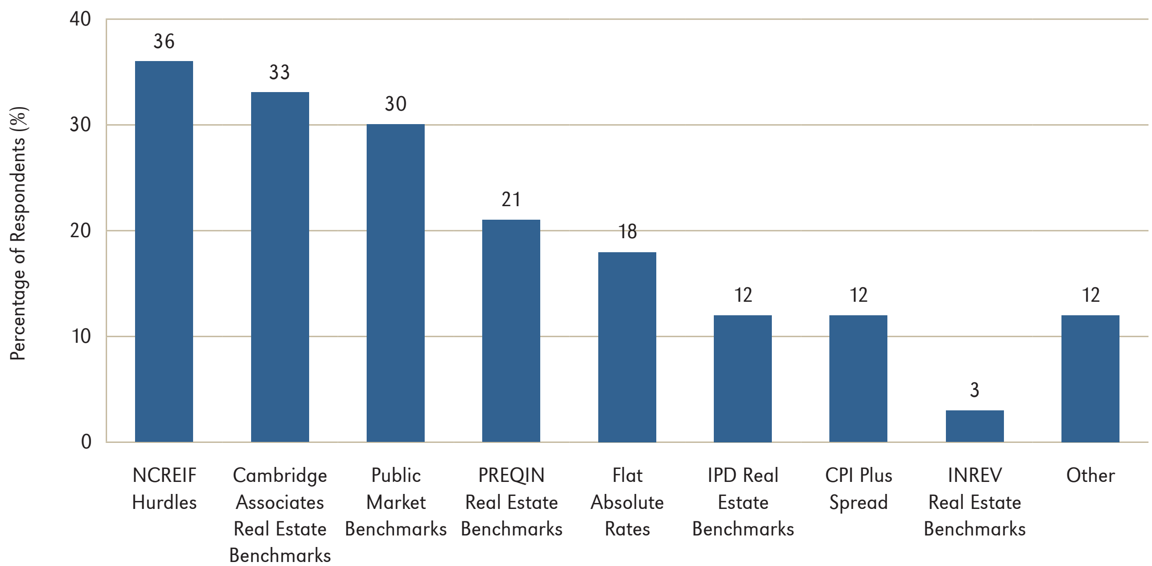
Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

Benchmarking

- There is not a single dominant benchmark for real estate investment performance (Chart XXVII), and many investors use multiple benchmarks.
- NCREIF, Cambridge and Public Market benchmarks are used by 30% or more of the respondents.
- There are also distinct differences geographically. Outside of North America, the two leading benchmarks are Flat Absolute Rates (45%) and PREQIN (28%), while North Americans prefer NCREIF hurdles (45%) and Cambridge (41%).
- Burgiss was not among the preselected options, but was selected enough as part of the "Other" category to garner 6% of responses.

Chart XXVII Portfolio Benchmarks

What benchmarks do you use for the return of your overall portfolio? (choose all that apply)



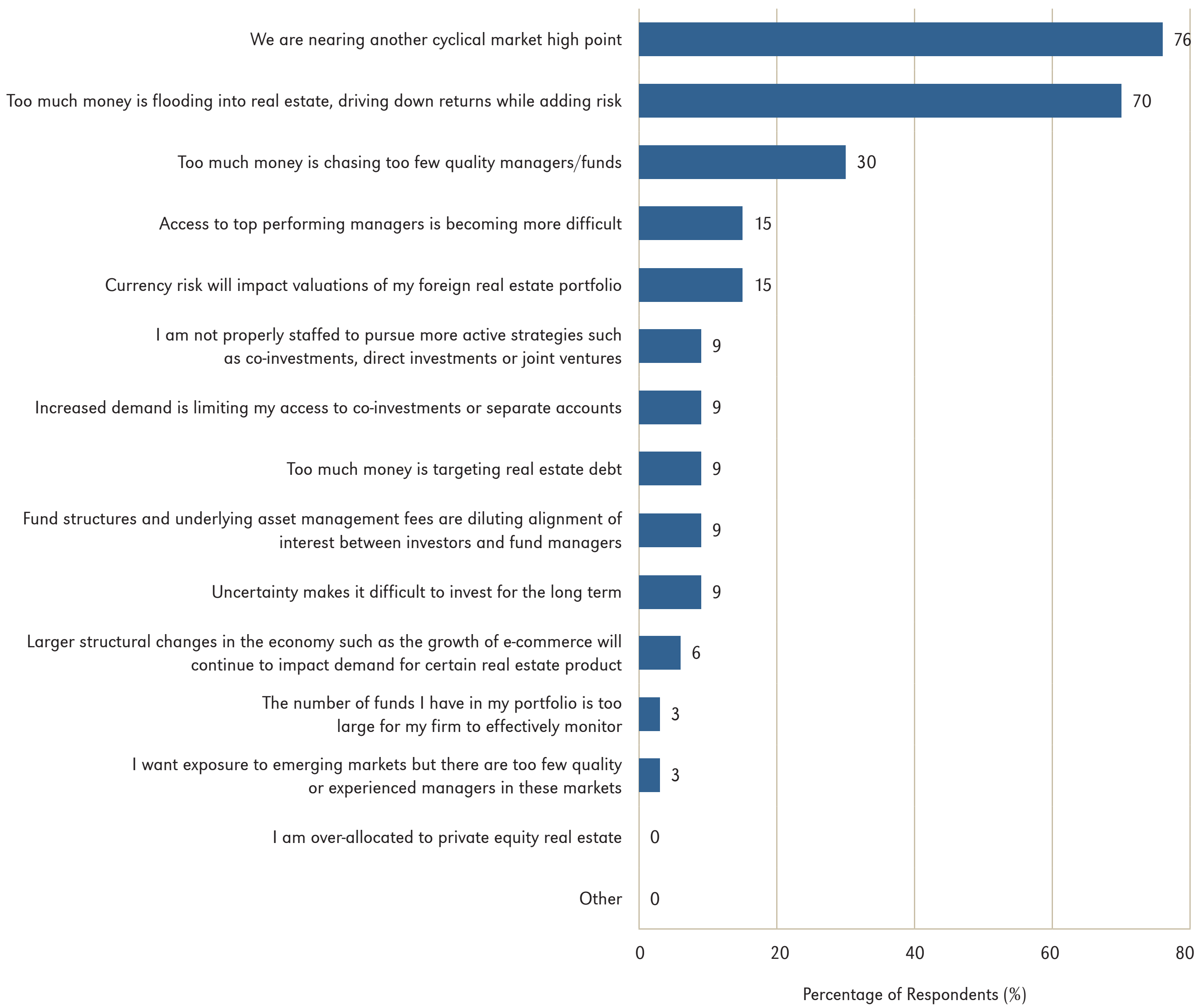
Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

Investor Fears and Concerns

- The greatest fear among investors is that we are at the top of a market cycle (Chart XXVIII). Fear that too much money is flooding into real estate — which has been the top concern for the last several years — was a concern for 70% of respondents, the only other response to attract more than a 30% response rate.
- Probitas Partners added the fear regarding the market reaching a cyclical peak to the survey in 2015. Over the last three years, that fear has moved from 52% of respondents selecting it to 69% last year and 76% this year.

Chart XXVIII Greatest Fears

My three greatest fears in the real estate market at this moment are:



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2017 Survey

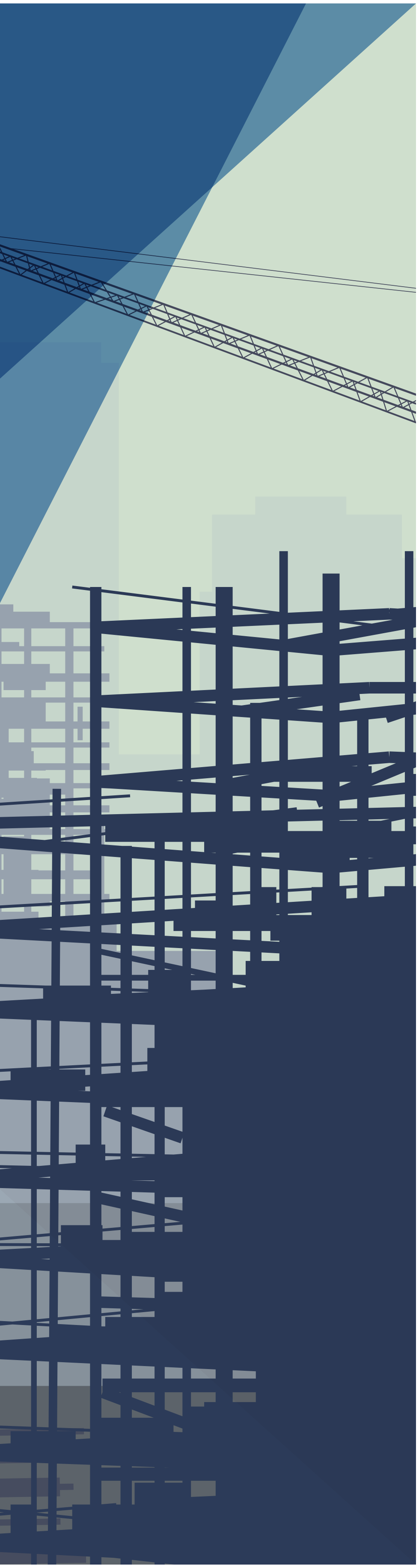
- Table II compares the three greatest fears from 2008 and 2017.
  - Potential credit problems were by far the biggest issue in 2008 as investors saw problems in their portfolios rapidly developing.
  - In 2017, investors fear we are at the top of a market cycle, as money pouring into real estate investment over the last five years has overwhelmed pricing discipline.

Table II What Keeps You Up at Night?
Top Three Responses

2008		2017	
Issue	**%**	**Issue**	**%**
Credit problems in Western or mature markets will dramatically impact performance	67%	We are nearing another cyclical market high point	76%
Capitalization rates will increase significantly impacting existing portfolio valuations	30%	Too much money is flooding into real estate, driving down returns while adding risk	70%
Fund structures and underlying property management fees are destroying alignment of interest between investors and fund managers	24%	Too much money is chasing too few quality managers/funds	30%

Source: Probitas Partners' Real Estate Institutional Investor Trends Survey, 2008 and 2017

The greatest fear among investors is that we are at the top of a market cycle



Our View of the Future

The results of the 2017 survey and our ongoing conversations with individual investors indicate several trends:

- ***Fundraising is likely to be stable over the next 12 months, but tensions in the market could reverse that quickly.*** Key factors driving this are the following:
  - Though distributions to investors have slowed, cash coming back is still driving a need to redeploy proceeds to maintain allocations at targeted levels.
  - Comparative risk-adjusted returns on many non-alternative investments are perceived to be unattractive as central banks continue to maintain or push down interest rates — though the glimmerings of a change have become more evident with the Federal Reserve.
  - There is still a growing fear that we are nearing the top of a market cycle. Though there is not a consensus on what might trigger a downturn, investors fear that the market is frothy, which means a negative reaction could develop quickly.
- ***Closed-end funds focused on value-added and opportunistic strategies will continue to attract investors who do not have the resources to invest directly.*** However, many of these investors are concerned that we are at the top of the market, with more downside risk than upside potential. They are very focused on manager quality that is not just a function of past financial performance but also demonstrated discipline in past cycles.
- ***Direct investors are still interested in core assets but the flood of capital that has been going into the sector is hurting returns.*** In the aftermath of the Lehman collapse, core assets — especially "trophy" assets — benefited from a flight to quality, as investors sought safety from the turmoil hitting highly leveraged opportunistic funds. However, continued flows of capital have made it increasingly difficult for core assets to make sense within a closed-end fund structure that charges fees and carry — and these capital flows are making it difficult for direct investors to hit return targets as well.
- ***Direct investments, separate accounts, and joint ventures will increasingly be a target of large investors.*** Investors continue to focus on lower investment fees. The direct strategies require more internal resources and experienced staff to execute effectively. This is not easy for smaller investors to replicate. The large investors active in these sectors are diverting significant amounts of capital away from closed-end funds into these strategies and will to continue to do so.

- ***Uncertainty in Europe: Brexit — and Frexit?*** The Brexit vote in 2016 was unexpected and caused uncertainty in the market — uncertainty that keeps going on due to the long process and negotiations required to leave the European Union and whether Brexit would end up being "hard" or "soft" or somewhere in between. This spring's elections in France have for the first time brought the topic of Frexit to the forefront of political discussions, though the results of the first round of the presidential elections leave the issue in doubt. A French exit from the European Union would have even more far reaching effects than Brexit, though it still seems an unlikely event at this point.

- ***Interest in emerging markets remains low.*** Emerging markets have not been a huge area of focus for real estate investors. For the past two years, over 50% of respondents to Probitas Partners' survey have declared that they do not invest in emerging markets. Many of the larger countries in the emerging markets have been going through economic or political difficulties which have decreased interest in those market leaders.

- ***Interest in emerging managers continues.*** Investors are increasingly looking to add alpha to their portfolios and are interested in doing so by backing new managers with distinct strategies or competitive advantages. On the other hand, established investors are not interested in investing in "just another opportunistic fund" or "just another value-added fund" — though exceptions are of course made for managers whose track record across market cycles is extremely compelling.

Our View of the Future

Real Estate Institutional Investor Trends for 2017 Survey

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