Real Estate Institutional Investor Trends: 2019 Survey Results

Probitas Partners

Contents

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 totals rebounded in 2018 (Chart I). The number of funds with a final close continued to increase during the year.

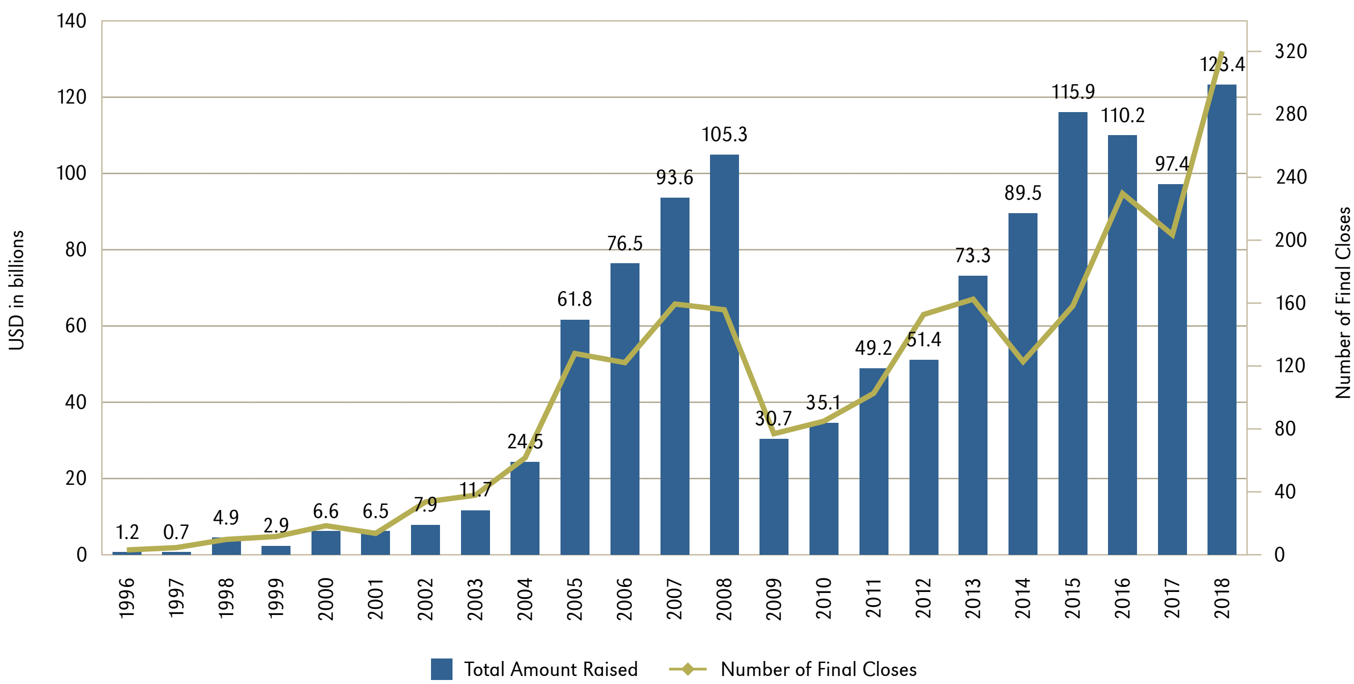
- North American-focused funds remained the leading geography in 2018, while European-focused funds ranked second (Chart II). As has been the case in the past, there was very little activity in the emerging markets outside of Asia.

- Value-added and opportunistic strategies dominated the fund market, making up two-thirds of capital raised (Chart III). However, there remains more interest in core and core-plus strategies among direct investors in real estate.

- There was also significant activity in the real estate debt market, making up 21% of capital raised.

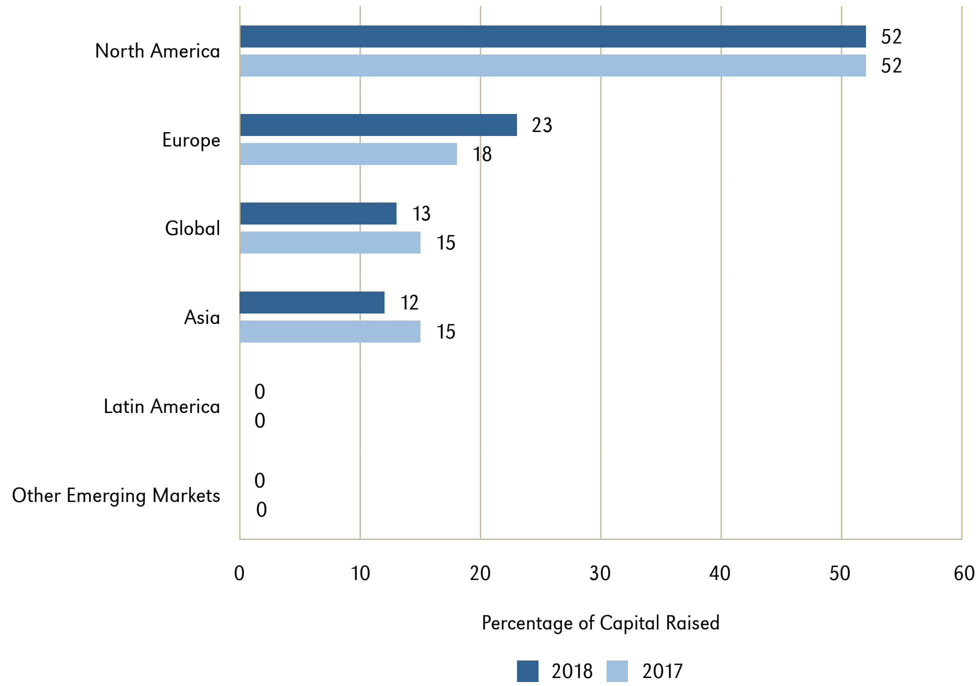
"Value-added and opportunistic strategies dominated the fund market, making up two-thirds of capital raised."

Chart I Global Real Estate Fundraising 1996 – 2018



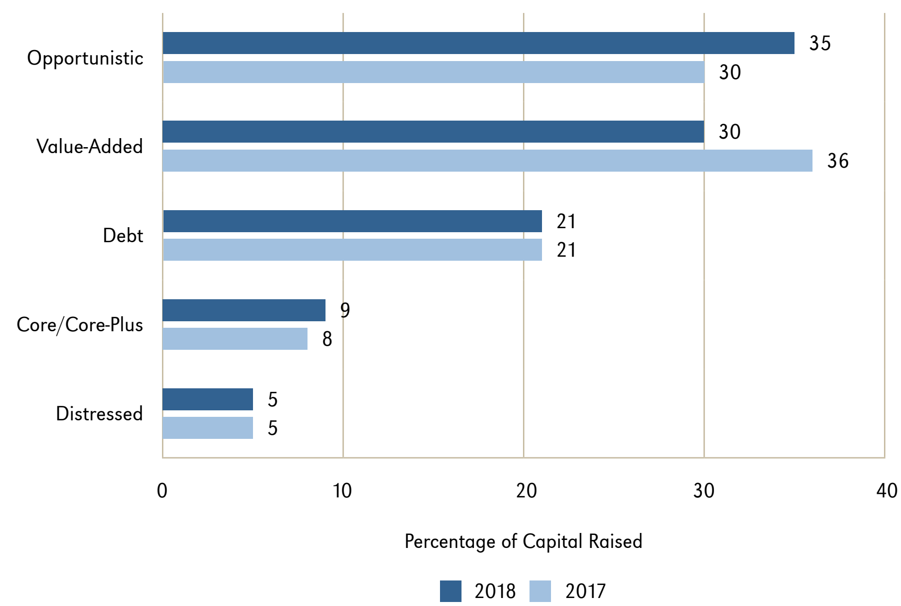
Source: Probitas Partners; PREQIN; PERE; IREI

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



Source: Probitas Partners; PREQIN

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



Source: Probitas Partners; PREQIN

- Table I details the ten largest funds that had a final close in 2018. These funds comprised over a third of the capital raised during the year, helping to drive overall fundraising. Three of these funds are focused on investing in the U.S. with another two having a transatlantic focus, investing in both the U.S. and Europe. Six of these funds have an opportunistic strategy — not unusual with large funds — while three are focused on debt. Landmark's fund is focused on real estate partnership secondaries and is by far the largest real estate secondary fund ever raised.

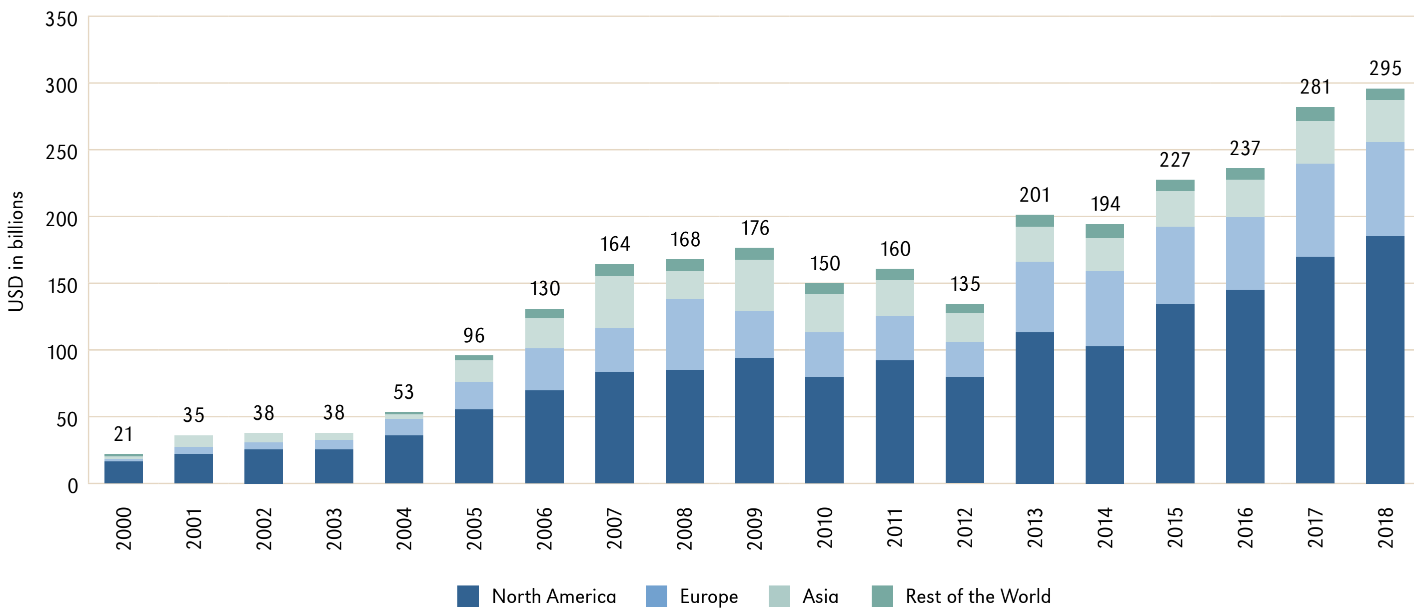
Table I Largest Real Estate Funds Raised with Final Close in 2018

Fund Name	Manager	Strategy	Geographic Focus	Amount Raised (MM)	Headquarters
Starwood Global Opportunity Fund XI	Starwood Capital Group	Opportunistic	Transatlantic	7,600 USD	Greenwich, CT
Blackstone Real Estate Partners Asia II	Blackstone Group	Opportunistic	Asia	7,100 USD	New York
Broad Street Real Estate Credit Partners III	Goldman Sachs	Debt	Transatlantic	6,438 USD	New York
Carlyle Realty Partners VIII	Carlyle Group	Opportunistic	United States	5,500 USD	Washington, DC
TPG Real Estate Fund III	TPG	Opportunistic	United States	3,700 USD	Fort Worth, TX
Landmark Real Estate Fund VIII	Landmark Partners	Secondaries	Global	3,300 USD	Simsbury, CT
AllianceBernstein Commercial Real Estate Debt Fund III	AllianceBernstein	Debt	United States	3,110 USD	New York
Aermont Capital Real Estate Fund IV	Aermont	Opportunistic	Europe	2,000 EUR	London
GLP Japan Development Partners III	GLP	Opportunistic	Japan	250,000 JPY	Singapore
Oaktree Real Estate Debt Fund II	Oaktree Capital Management	Debt	Global	2,087 USD	Los Angeles

Source: PREQIN; Probitas Partners
Note: Does not include funds-of-funds

- Beyond tracking annual fundraising totals, monitoring the aggregate amount of "dry powder" is a key factor in assessing potential competition and resulting pricing in the market. The increase in fundraising in 2018 drove dry powder up, with North America leading the way, reaching a new peak (Chart IV).

Chart IV Real Estate Dry Powder by Geography



Source: PREQIN, as of February 2019

"Landmark's fund is focused on real estate partnership secondaries and is by far the largest real estate secondary fund ever raised."

Real Estate Institutional Investor Survey

Probitas Partners conducts its survey of institutional investors in real estate annually to determine their perspectives on the market. We received responses globally from senior investment staff representing such institutions as pension plans, funds-of-funds, endowments and foundations, consultants, and banks.

Overview of Survey Findings

The top-line findings from the survey, supplemented by our ongoing conversations with investors, are as follows:

- ***Investors are increasingly concerned that there is too much money in the market and that we are reaching or have reached a cyclical market peak.*** Though fundraising for closed-end real estate funds rebounded in 2018, those fears remain. Persistently, investors express concerns about frothy market pricing and the challenges they hear from managers in finding well-priced deals.

- ***Dry powder remains an issue in investors' minds.*** Dry powder increased slightly — as it has every year since 2014 — driven by an increase in North American-focused raises.

- ***The shift toward value-added and opportunistic funds and away from core continues.*** Many fund investors feel that too much money has gone into core assets over the last decade. Pricing is at historic highs in many markets. The result is that returns have been driven so low as to be unattractive in achieving portfolio return goals, especially in fund formats. Consequently, many fund investors are continuing to rotate allocations to higher returns in the opportunistic and value-added sectors.

- ***North America remains a geographic focus for many investors.*** North American closed-end funds have always been the primary target of institutional investors. Interest in Europe remains strong, with several investors citing that market as offering better risk-return opportunities. There continues to be virtually no interest in emerging markets outside of Asia.

- ***The multi-family sector remained the top sector preference.*** Student housing and senior housing — allied sectors to multi-family — also scored strongly. Other niche sectors, such as medical buildings and manufactured housing, continue to draw interest from investors seeking differentiated portfolio exposure from the primary product types.

"Persistently, investors express concerns about frothy market pricing and the challenges they hear from managers in finding well-priced deals."

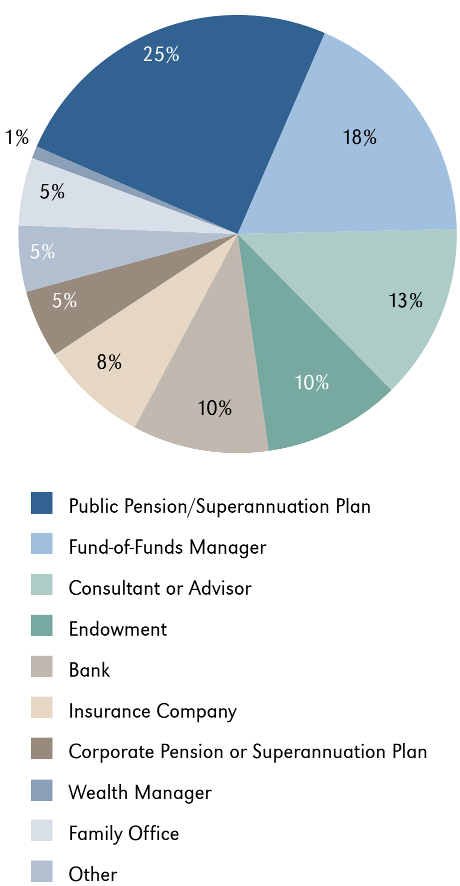
Profile of Respondents

- Participation from pension plans, funds-of-funds, consultants, endowments/foundations and banks made for a diverse group of respondents with varying motivations (Chart V).
- Respondents from the U.S. made up nearly half of the participants — not surprising as the U.S. is the deepest and most established private institutional real estate fund market (Chart VI). Asian investors were 27% of respondents, and 20% came from Europe.

"Respondents from the U.S. made up nearly half of the participants — not surprising as the U.S. is the deepest and most established private institutional real estate fund market."

Chart V Respondents Categorized by Investor Type

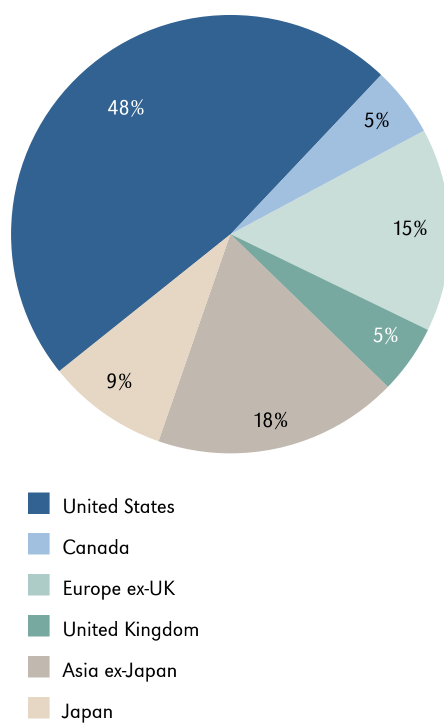
I represent a:



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

Chart VI Respondents Categorized by Firm Headquarters

My firm is headquartered in:

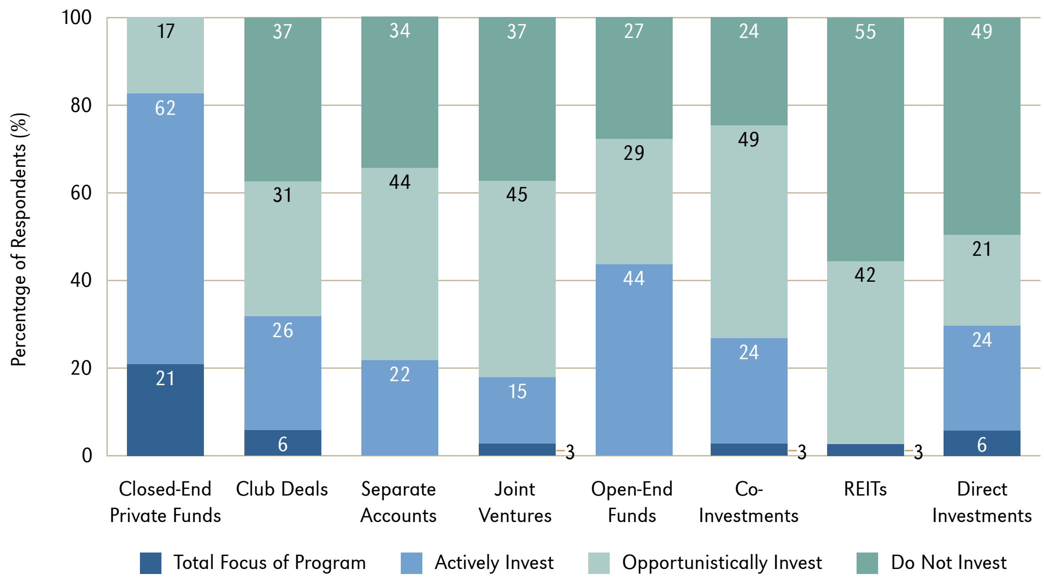


Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

- A majority of respondents target closed-end private funds, and for 21% these funds were their exclusive focus (Chart VII). Co-investments and open-ended funds also had a significant number of adherents.
- Although 6% of respondents said direct investments were the sole focus of their program, nearly half of the respondents do not consider directs at all.

Chart VII Real Estate Investment Structures

We invest via:

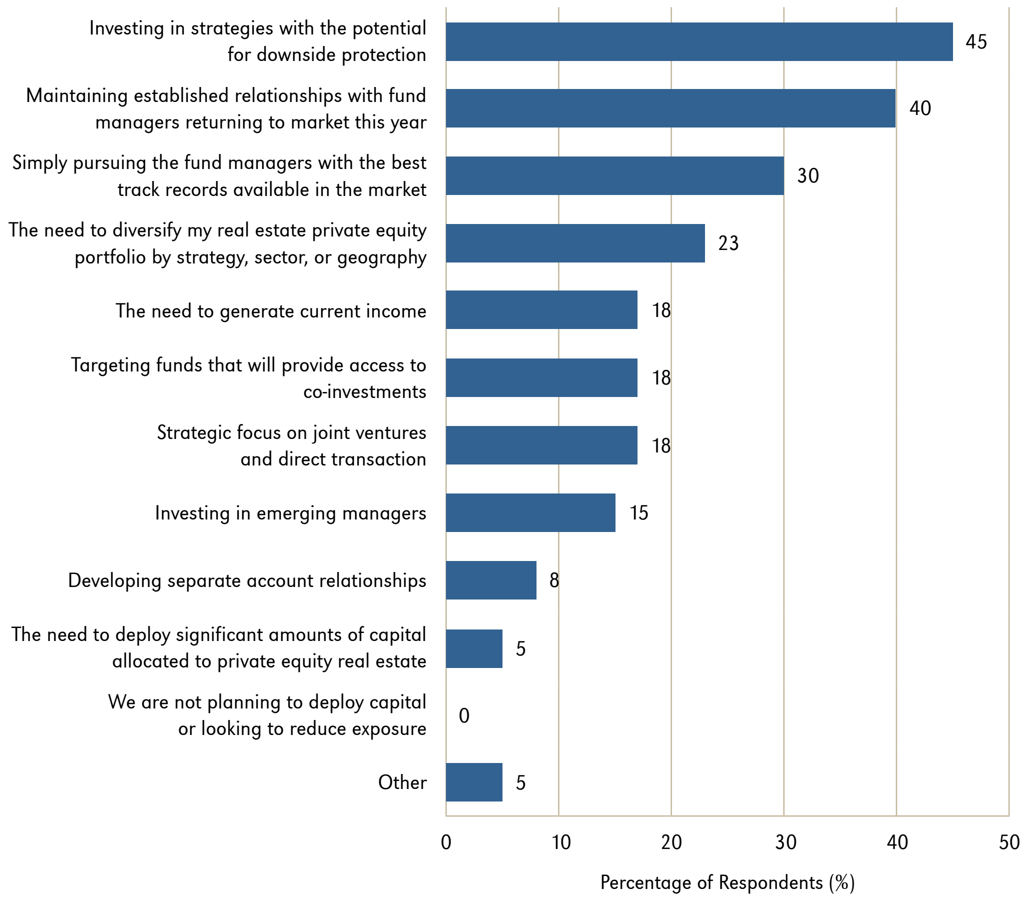


Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

- In response to persistent feedback in dialog with our investors, this year for the first time we added the potential response "Investing in strategies with the potential for downside protection." It was the most popular response, with 45% of investors selecting it (Chart VIII). Perhaps in part because of this new choice, last year's top response, "Maintaining established relationships with fund managers," fell from 54% last year to 40% this year.
- Last year's second-ranked response of simply pursuing the fund managers with the best track record fell to third place this year, although the number of investors selecting it rose from 24% to 30%.

Chart VIII Drivers of Investment Focus

Our 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: 2019 Survey Results

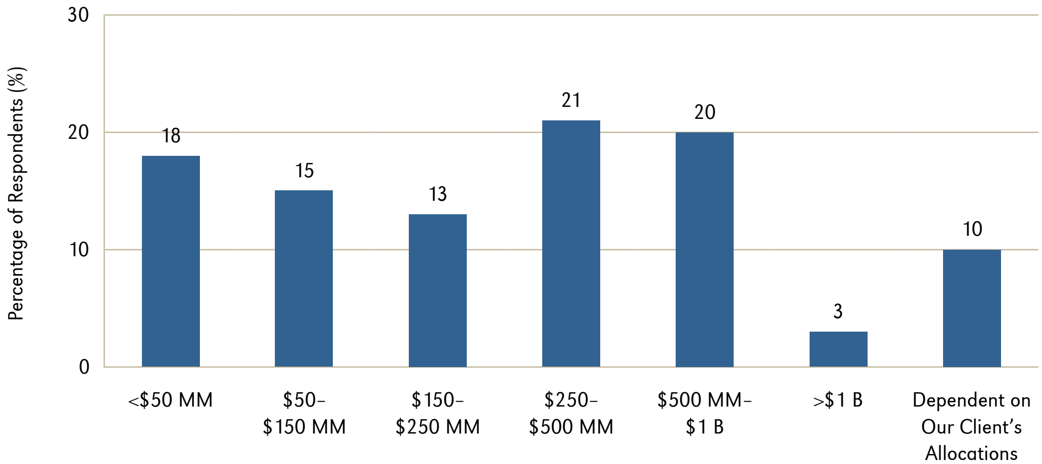
- Investors' likely new allocations for 2019 varied significantly. At one end of the spectrum, 18% of investors intended to invest $50 million or less over the next year, while at the other end 20% of respondents stated that they planned to invest $500 million or more (Chart IX).

- Similarly, the average anticipated size of commitments that respondents planned to make to individual funds varied significantly (Chart X).

- As far as investors' focus over the coming year, most respondents expect to deal with a large number of re-ups and only have the bandwidth for limited new manager selection. Some 30% of investors expect to be totally focused on re-ups (Chart XI). Interest in co-investments remained steady, edging down slightly to 28% this year from 29% last year.

Chart IX Real Estate Allocations

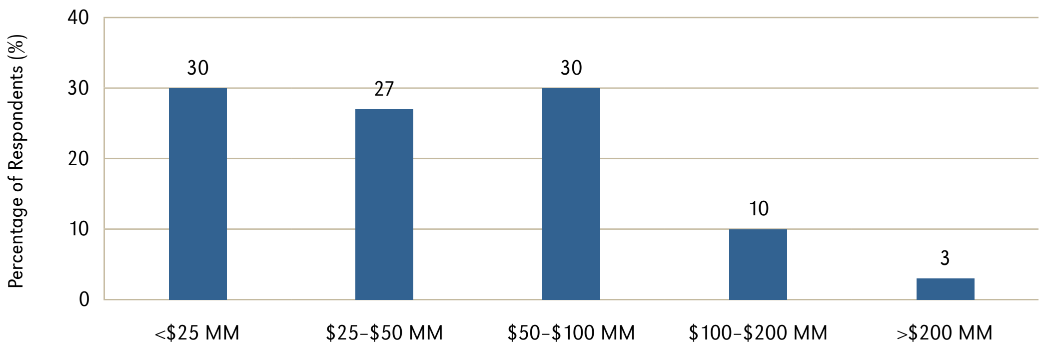
Over the next year, we are looking to commit across all areas of real estate (in USD):



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

Chart X Average Size of Investment

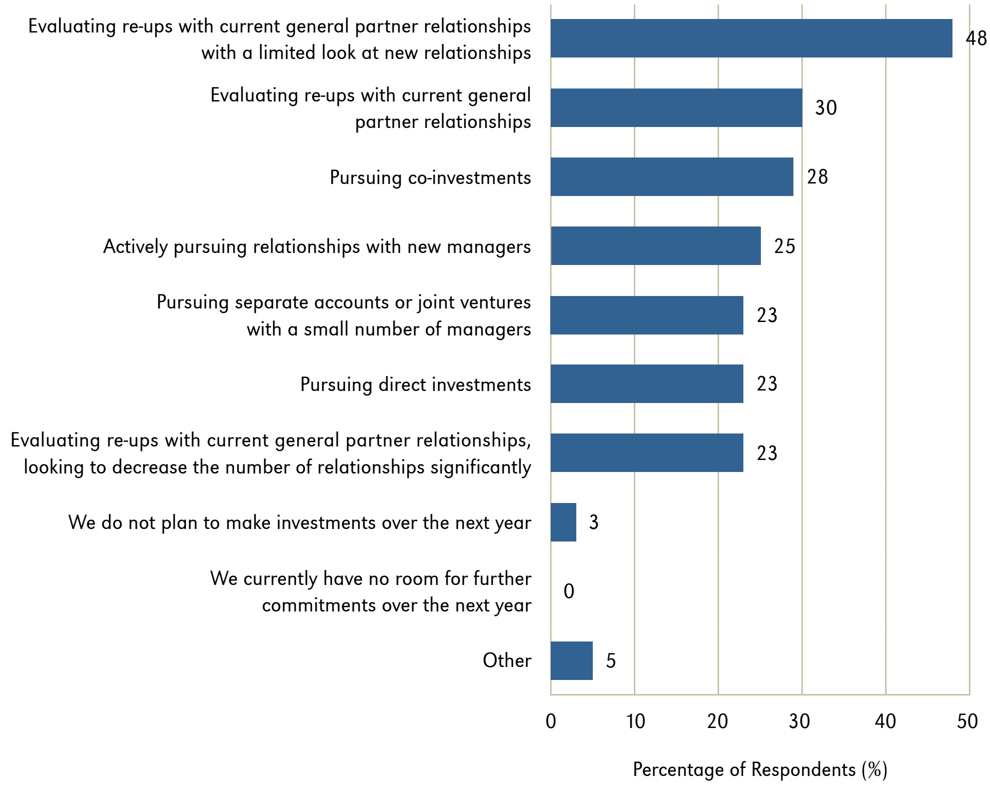
Over the next year, we expect our institution's average investment size in real estate investments to be (in USD):



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

Chart XI Private Equity Real Estate Focus

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



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

> *"Most respondents expect to deal with a large number of re-ups and only have the bandwidth for limited new manager selection."*

Sectors of Interest

- Interest in core investment strategies by fund investors has declined considerably over the last four years as investors have sought higher returns in value-added and opportunistic strategies. In 2015, 22% of respondents to our survey were solely focused on core investments. By this year that number had fallen dramatically to 8% (Chart XII), though that is up from 0% last year.

- Though a large number of respondents do not invest in real estate debt funds, interest in various debt strategies increased this year, especially for distressed debt and senior debt. We also believe that many investors make investments in senior debt from dedicated credit allocations outside real estate that are not captured in our survey.

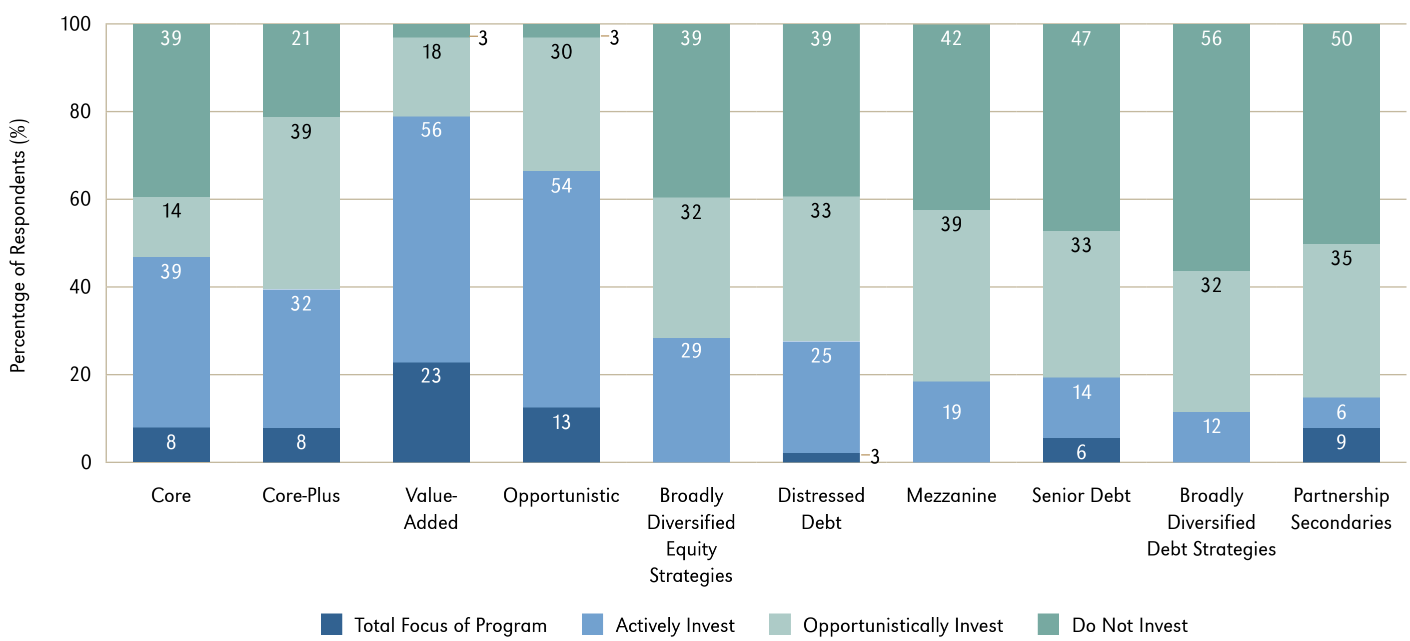
- The newest sector of real estate investing is partnership secondaries where, after nearly a decade of fits and spurts, interest appears to be increasing.

- As far as industry sectors, the multi-family sector remained the strongest area of focus, increasing from 71% last year to 79% this year. The warehouse/logistics sector retained the second ranking, increasing significantly from 58% to 69%. The office sector was the only other one to attract interest from at least 40% of respondents (Chart XIII).

- However, there are some regional differences between respondents. For non-North American investors, the office sector ranks second, tied with warehouse/logistics at 63%. For North American investors, the third ranked sector was medical buildings at 40%, while only 20% of North Americans are targeting the office sector.

Chart XII Real Estate Investment Strategies

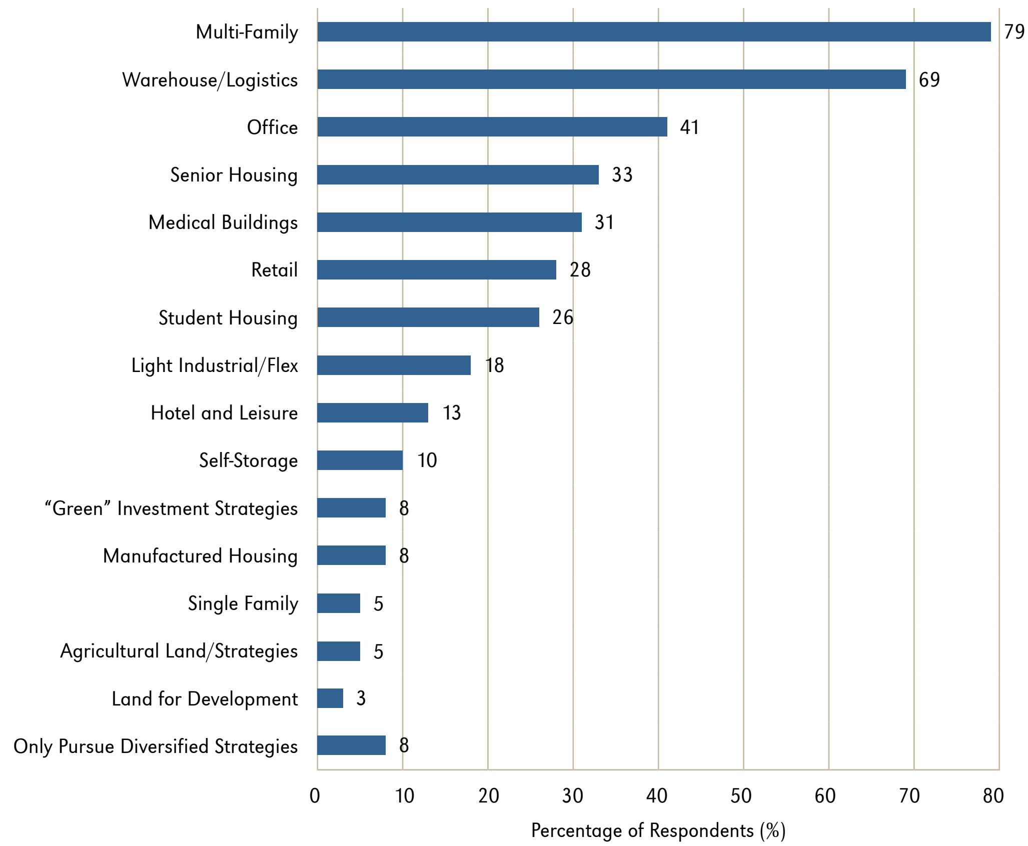
As far as risk/return strategies for funds or properties, we focus on:



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

Chart XIII Real Estate Sector Preferences

For the various industry sectors or subsectors of real estate globally, we are most interested in (choose no more than five):



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

"The multi-family sector remained the strongest area of focus, increasing from 71% last year to 79% this year."

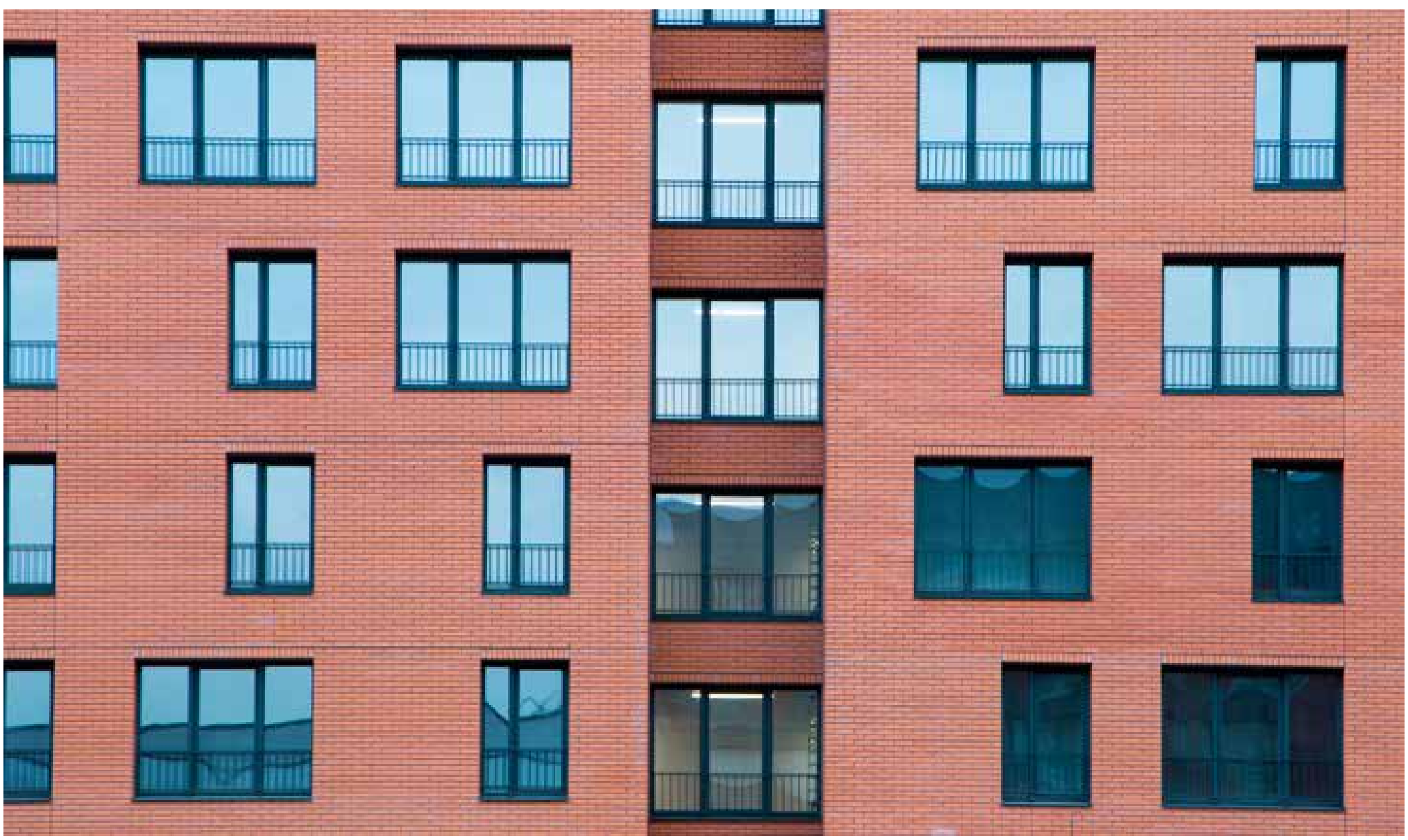
- To provide some perspective on how investor interest in property sectors changes over time, Table II compares the top five property sectors of 2007's survey (taken just before the Great Financial Crisis ("GFC") to responses to the latest survey. Over the last thirteen years, niche sectors have become more relevant as the institutional market has expanded. As a result, our most recent surveys have more preset options from which respondents can choose and the surveys have always allowed respondents to enter options that were not predetermined.
- Responses in these two periods show the evolution of the market. The warehouse/logistics sector was not a predetermined option in 2007, and it received no write-in votes. In 2019 it was the second-ranked sector, with 69% of investors targeting it. Senior housing and medical buildings, which also were not on the 2007 list, ranked fourth and fifth. The hotel and leisure sector, which was in fifth place in 2007's survey (though only 5% targeted it), ranked only ninth in 2019.

Table II Institutional Investors Focus of Attention Among Real Estate Sectors

Top Five Responses

2007		2019	
Sector	**% Targeting**	**Sector**	**% Targeting**
Office	27%	Multi-Family	79%
Multi-Family	27%	Warehouse/Logistics	69%
Industrial	23%	Office	41%
Retail	14%	Senior Housing	33%
Hotel and Leisure	5%	Medical Buildings	31%

Source: Probitas Partners' Real Estate Institutional Investor Trends: 2007 and 2019 Survey Results



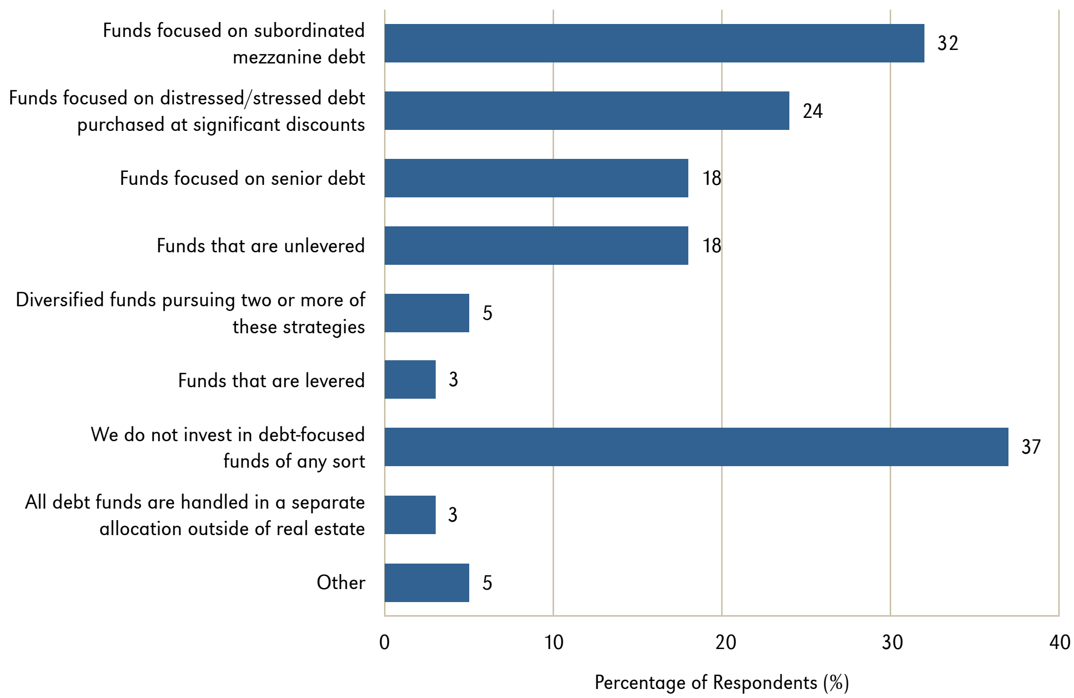
- Chart XIV delves deeper into interest in debt funds. In the wake of the GFC, as banks came under increasing regulatory pressure, real estate debt fundraising grew significantly by providing alternative sources of debt. Notwithstanding this significant expansion of private debt, 37% of respondents do not invest in real estate debt funds (Chart XIV).

- Last year, interest in the three main debt strategies of senior, mezzanine and distressed debt was relatively flat. This year, interest in mezzanine and distressed debt increased notably ahead of senior debt.

- Last year, investors did not have a strong preference between levered or unlevered funds. This year, 18% of respondents favored unlevered funds while only 3% preferred levered funds.

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: 2019 Survey Results

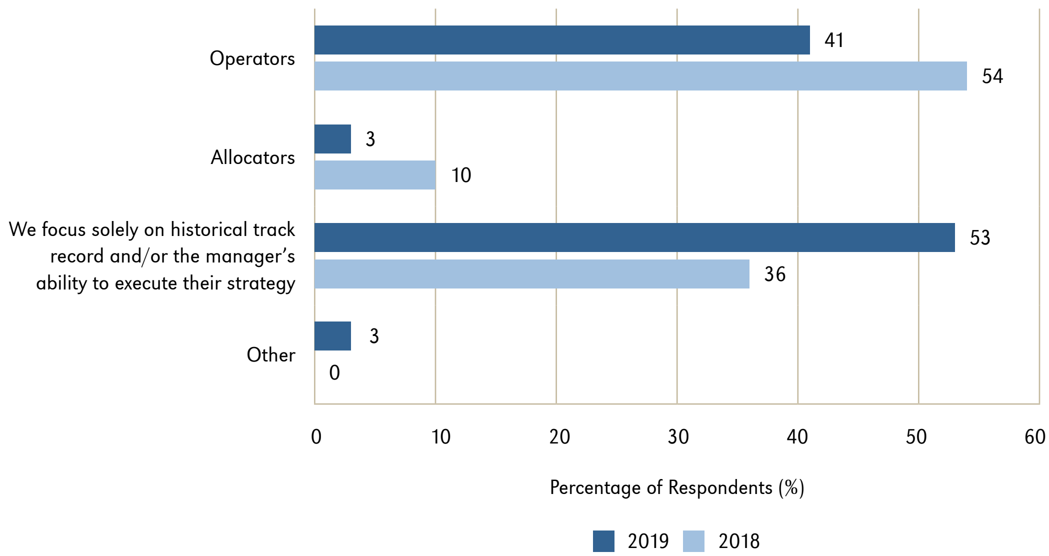
> *"This year, interest in mezzanine and distressed debt increased notably ahead of senior debt."*

- Besides the distinctions between investment strategy and industry sector focus, one of the dominant investment execution differences between fund managers is whether they apply an "operator" (actively operate properties) or "allocator" (allocate capital to underlying developers and property managers) approach. Chart XV shows that, while operators are strongly favored over allocators, a majority of respondents this year favor fund managers with a strong track record and are increasingly indifferent to the distinction, looking instead at historic performance, no matter the investment style.

- Non-North American investors remain more focused on historical track records than do North American respondents (Chart XVI).

Chart XV Manager Investment Style

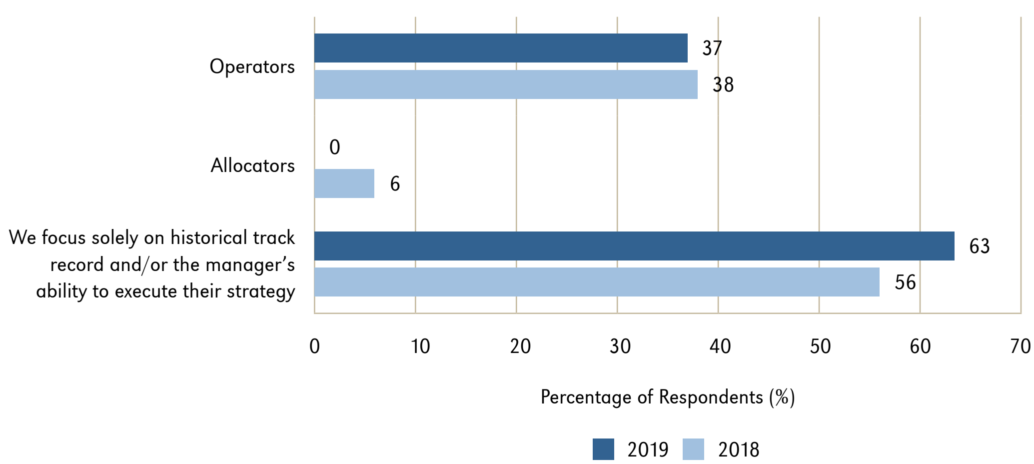
As far as manager investment style, we are more focused on:



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results and 2018 Survey Results

Chart XVI Manager Investment Style — Non-North American Respondents

As far as manager investment style, we are more focused on:



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results and 2018 Survey Results

"A majority of respondents this year favor fund managers with a strong track record and are increasingly indifferent to the distinction [between operator and allocator investment styles]."

Geographies of Interest

- North American-focused funds maintained their position as the number one geography of interest, exactly matching the 67% who targeted it last year (Chart XVII). Interest in Pan-European funds increased from 36% last year to 46%, retaining the second-place ranking.

- Interest in both Pan-Asian and Asian country-focused funds increased this year — with country-focused funds, in particular, moving from 10% to 21%.

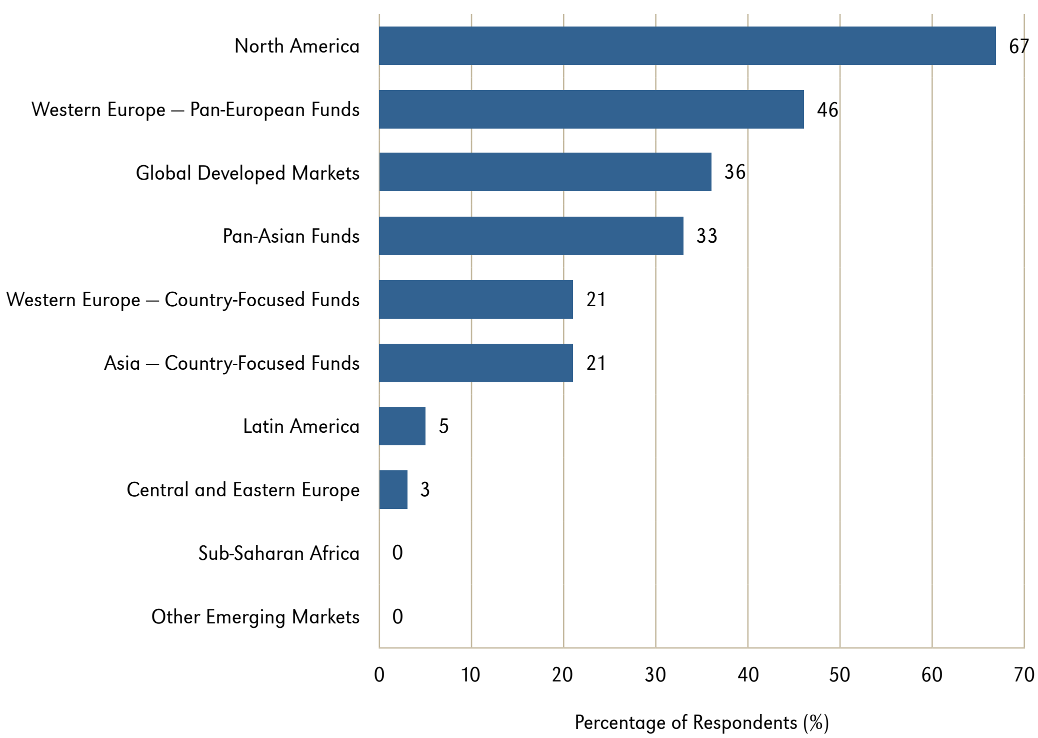
- There is little investor interest in the emerging markets outside of Asia, with Latin America leading, but with only 5% of investors targeting it.

- There are large differences between North American respondents and others (Chart XVIII). North Americans are heavily focused on North American funds and are less interested in Asian funds and European country-focused funds. Non-North Americans are less interested in U.S.-focused funds in part because of the tax consequences of FIRPTA.

"North American-focused funds maintained their position as the number one geography of interest, exactly matching the 67% who targeted it last year."

Chart XVII Geographic Focus

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



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

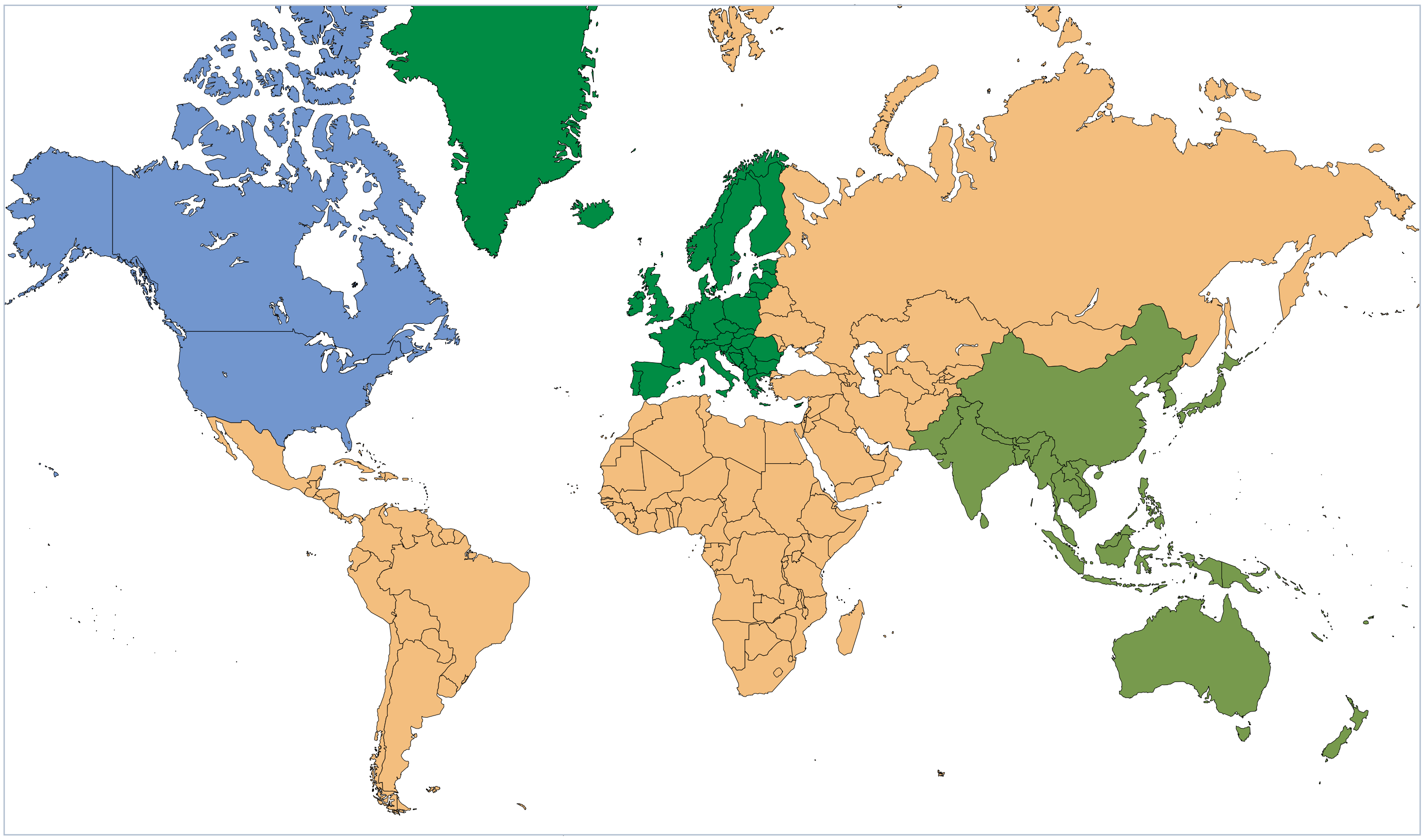
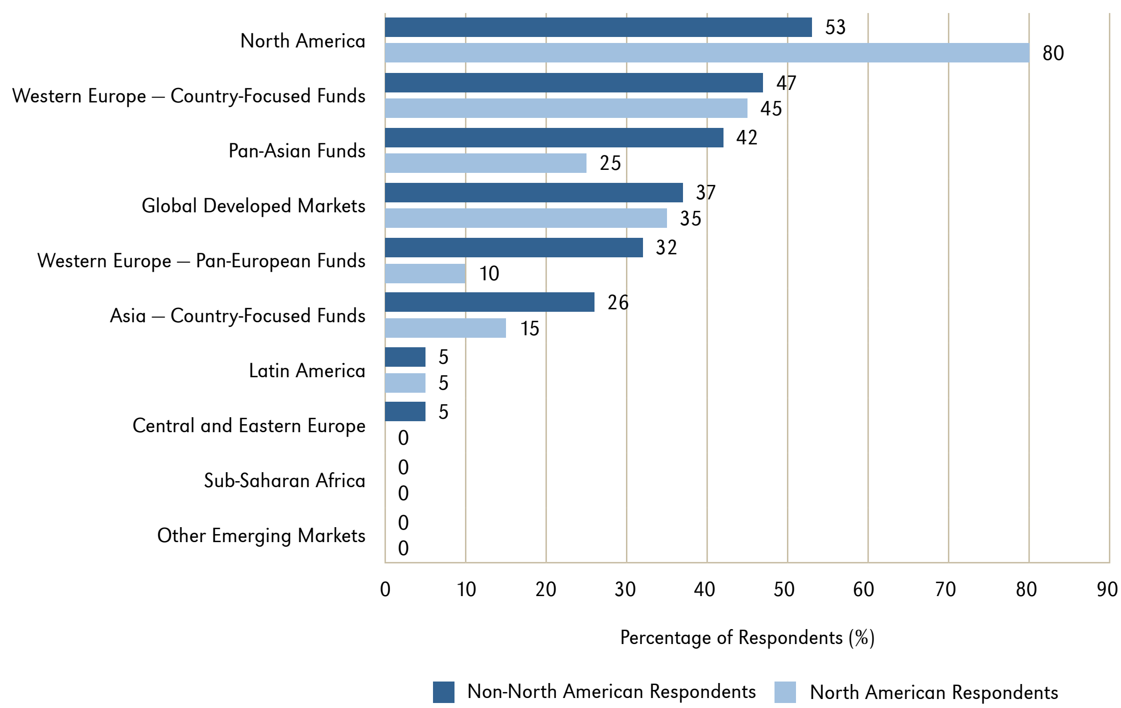


Chart XVIII Geographic Focus (by Region) — by Geography of Respondents

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



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

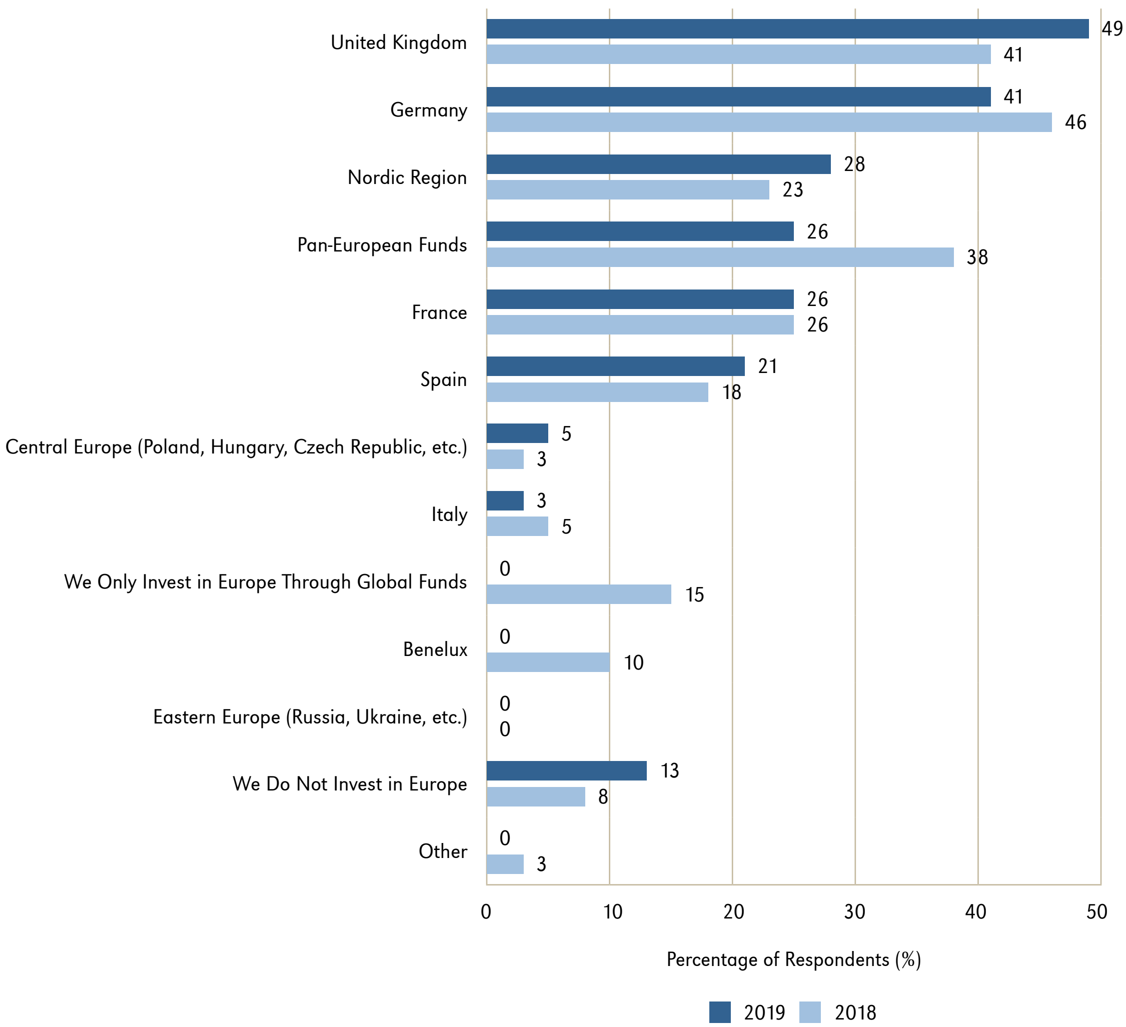
- UK and Nordic-focused funds increased in investor interest. Though interest in Germany decreased, it still ranked second (Chart XIX).

- Interest in Pan-European funds declined significantly from 38% last year to 26% this year. Interest in France and Italy remained unchanged.

- As with the last four years, no investors targeted Russia and Eastern Europe, and interest in Central Europe remained weak even though many of these countries are in the EU.

Chart XIX Most Attractive Markets in Europe

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



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results and 2018 Survey Results

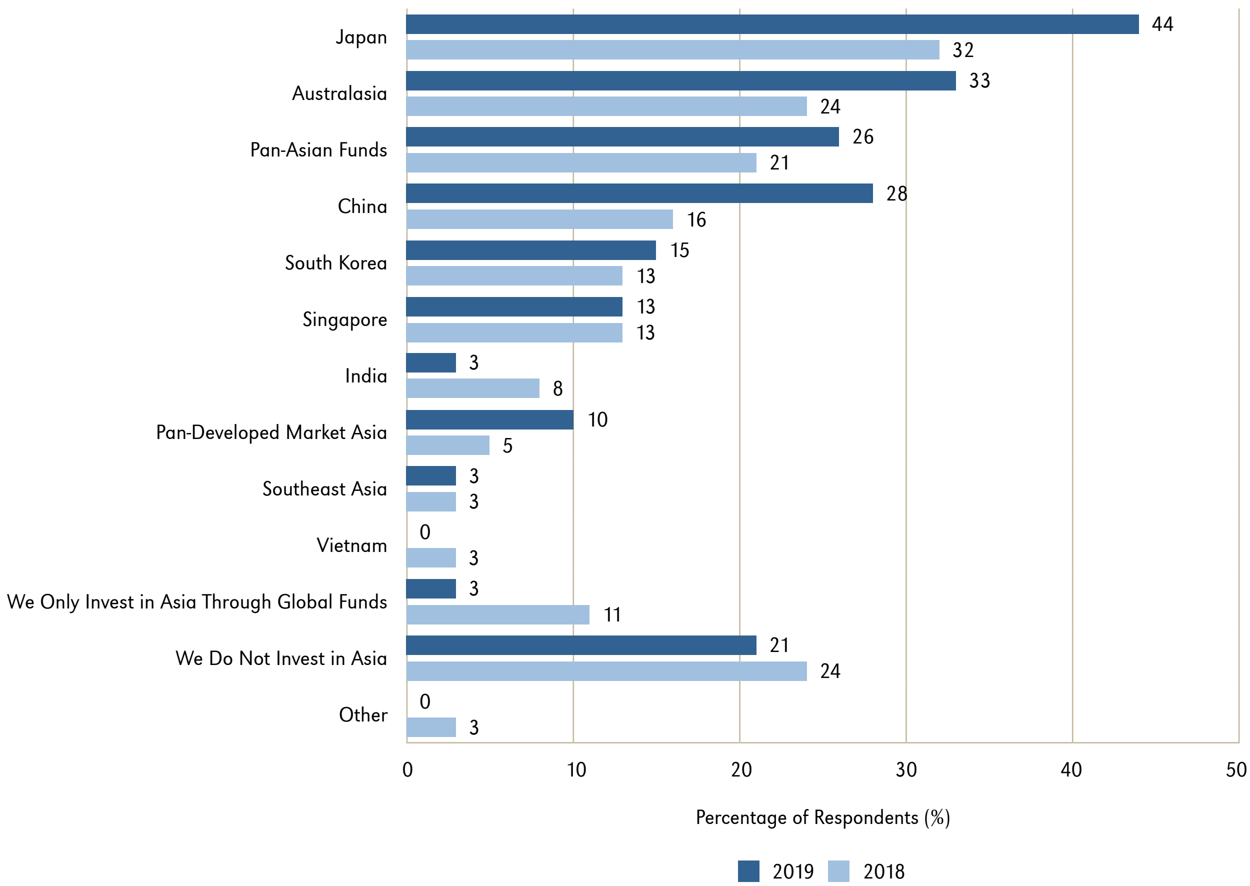
- Across the major markets in Asia and Australia, there was an increase in investor interest (Chart XX). Japan was the strongest geography of interest, attracting not only a large number of Japanese respondents who favored their home market, but also a large number of North American investors.

- China had a significant rebound in investor focus, moving from 16% last year to 28% this year — though it was still down from its high of 36% five years ago.

- The only country with a large decrease in interest was India.

Chart XX Most Attractive Asian Markets

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



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results and 2018 Survey Results

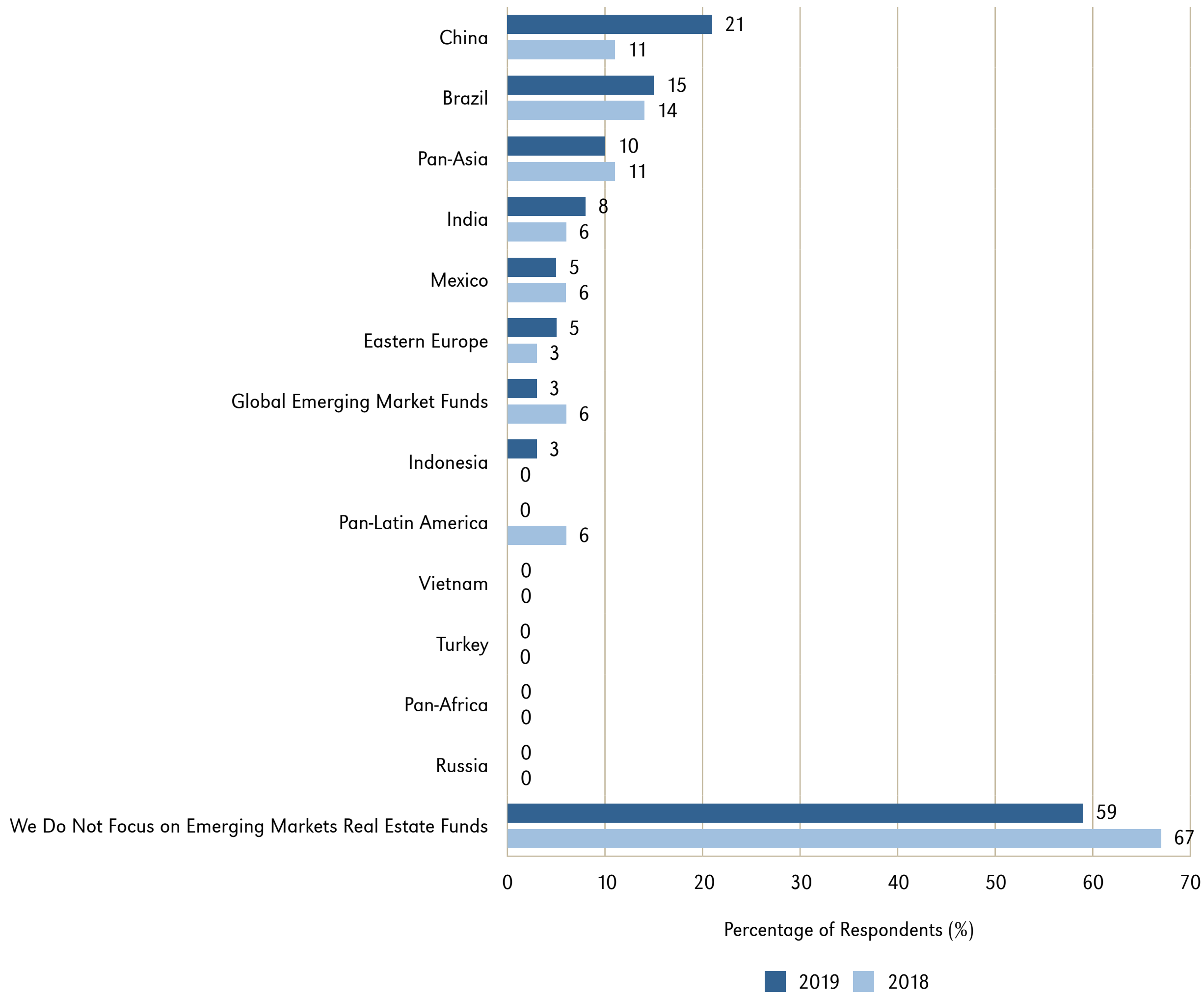
> *"China had a significant rebound in investor focus, moving from 16% last year to 28% this year."*

Emerging Markets

- Few investors were strongly interested in emerging markets. The vast majority of investors reported that they do not focus on emerging markets at all (Chart XXI).
- China regained the lead that it had previously held as the top emerging market of interest in our past surveys, with interest nearly doubling from 11% last year to 21%.
- Last year's leader, Brazil, had continued interest, with the second highest ranking even though it attracted slightly more interest this year.
- No emerging market geography attracted the focus of more than 10% of investors besides Brazil, China, or Pan-Asian funds.

Chart XXI Most Attractive Emerging Markets

For emerging markets, we are targeting (choose no more than three):



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results and 2018 Survey Results

The Secondary Market

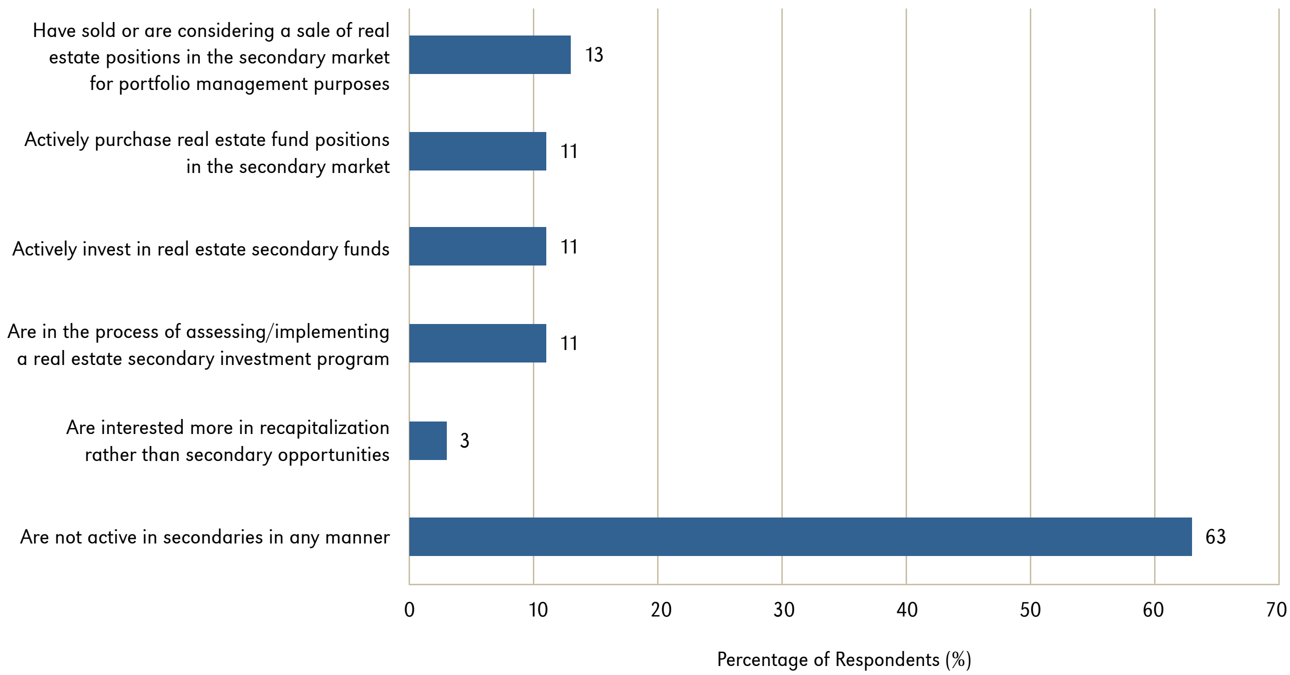
- Partnership secondaries in real estate remain a smaller part of the market compared with private equity, and it is still nascent, with limited focus by investors. 63% of respondents said that they were not active in secondaries in any manner, an increase from the 49% who responded that way last year (Chart XXII).

- On the other hand, fundraising for specialist secondary funds tells a different story. Commitments raised in 2018 hit an all-time high (Chart XXIII), with Landmark raising the largest fund of its kind ever.

- As with private equity secondaries, fundraising totals in Chart XXIII understate the commitments targeting real estate secondaries as they only cover specialized secondary funds and do not account for capital from direct investors and other sources.

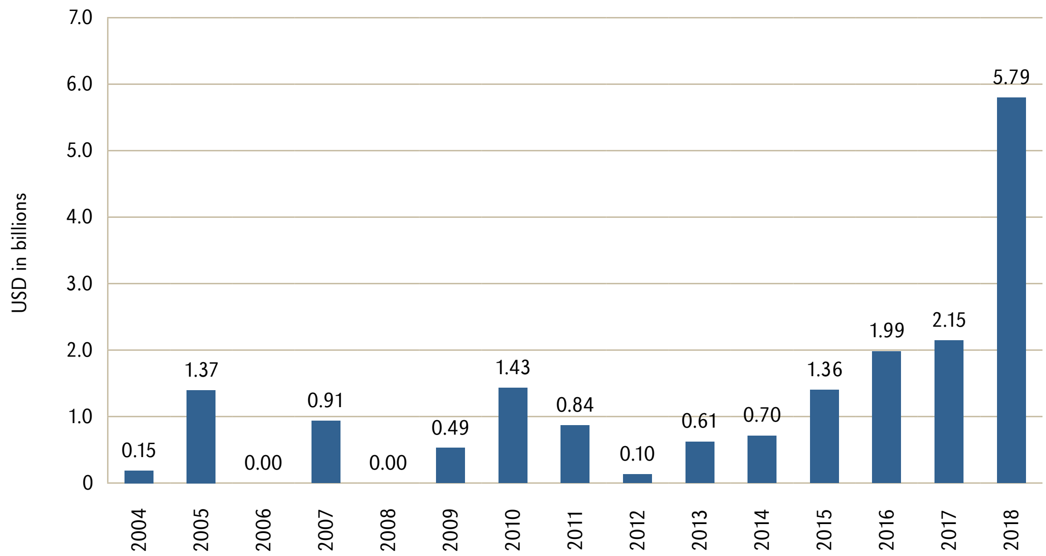
Chart XXII Secondary Market Investments

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



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

Chart XXIII Specialist Real Estate Secondary Fundraising 2004 – 2018



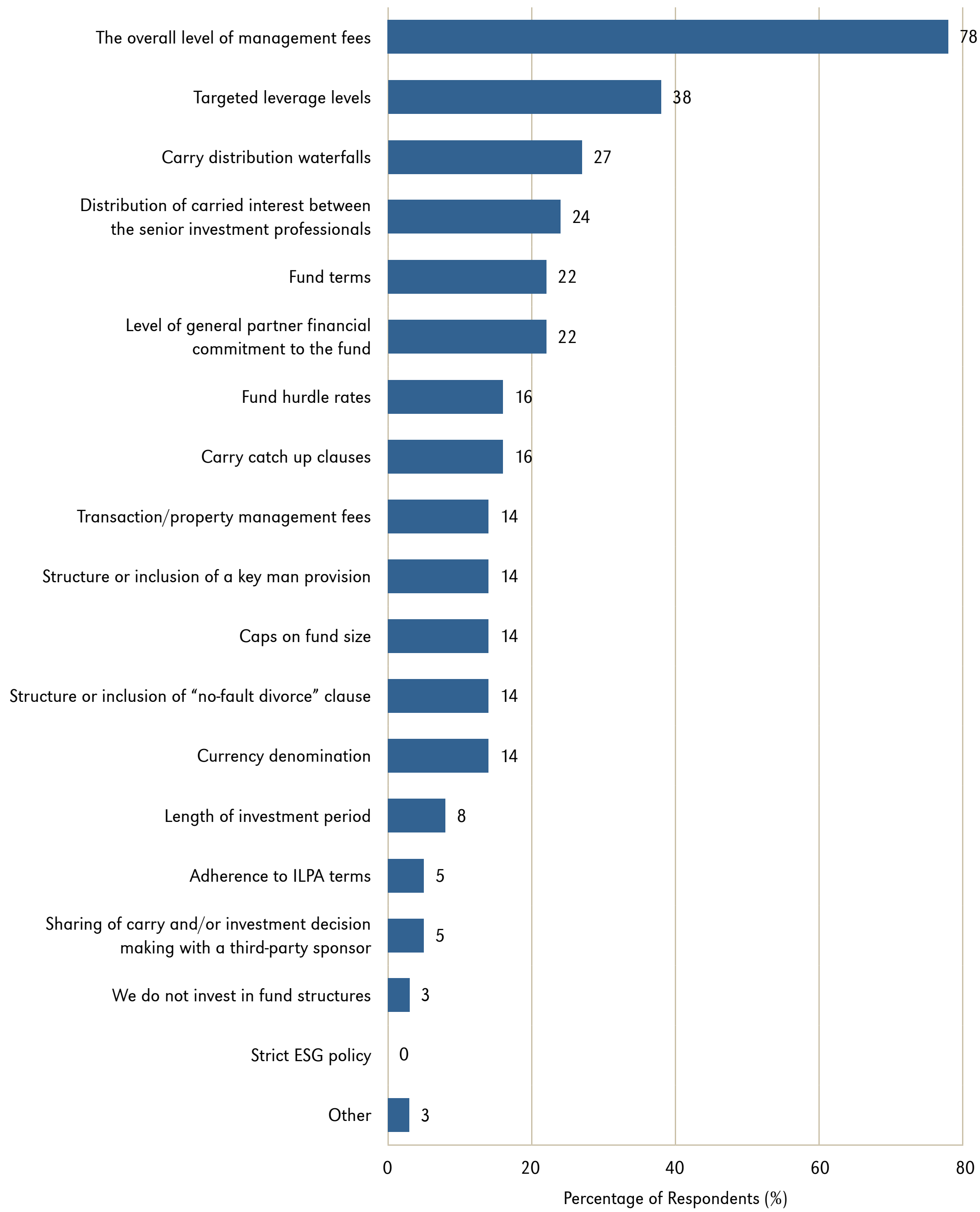
Source: Probitas Partners; PREQIN

Key Terms and Emerging Managers

- As with virtually all our past surveys, the level of management fees was by far investors' top focus (Chart XXIV). The focus on carry distribution waterfalls has varied over the last three years, moving from 30% in 2017, soaring to 53% in 2018, then plunging to 27% this year. The focus on targeted leverage levels has remained steadily of interest.
- This year not a single respondent targeted strict Environmental, Social and Governance ("ESG") policies (and only 3% targeted last year), even as ESG has become a major topic for discussion in private equity and infrastructure.

Chart XXIV Issues Regarding Terms or Fund Structure

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

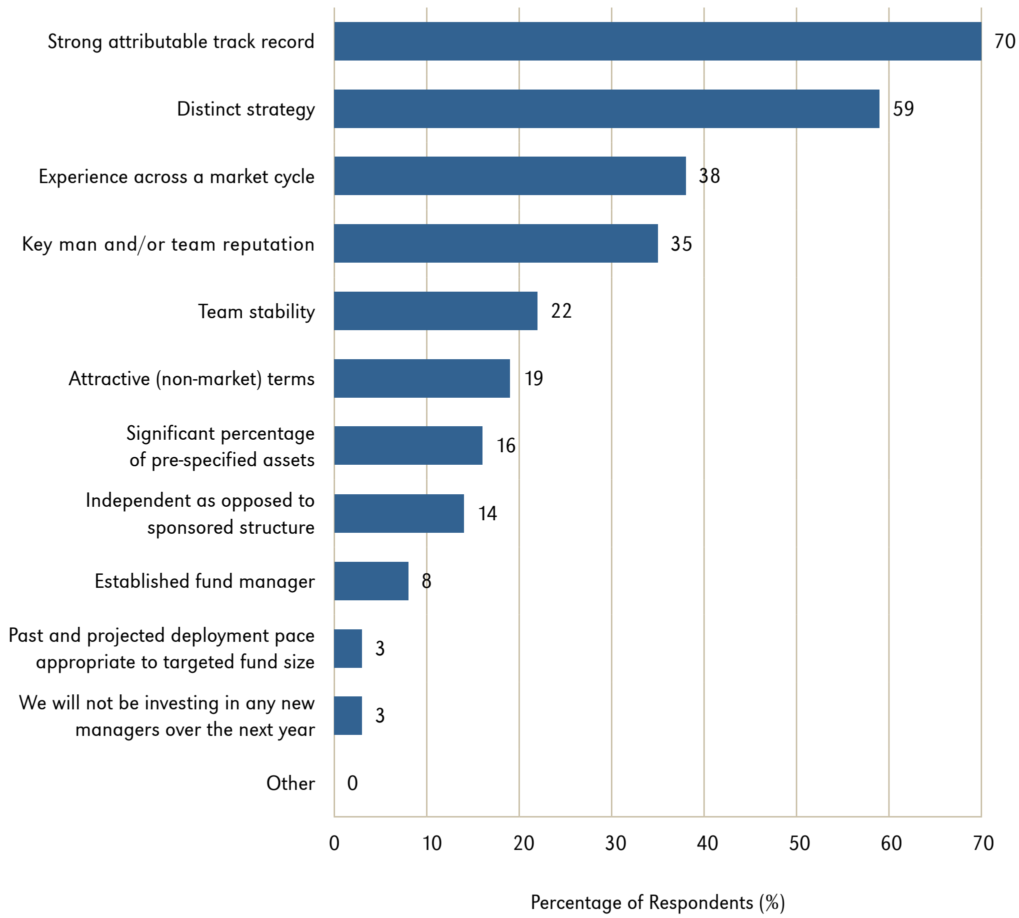


Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

- Investors have consistently been focused on strong, attributable track records when reviewing new fund managers and this year was no exception (Chart XXV).
- Having a distinct strategy was the only other criteria that attracted more than 50% of responses this year. Last year, experience across a market cycle ranked second, with 53% of respondents targeting it; this year it fell to third place at 38%.

Chart XXV Key Characteristics of New Fund Managers

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

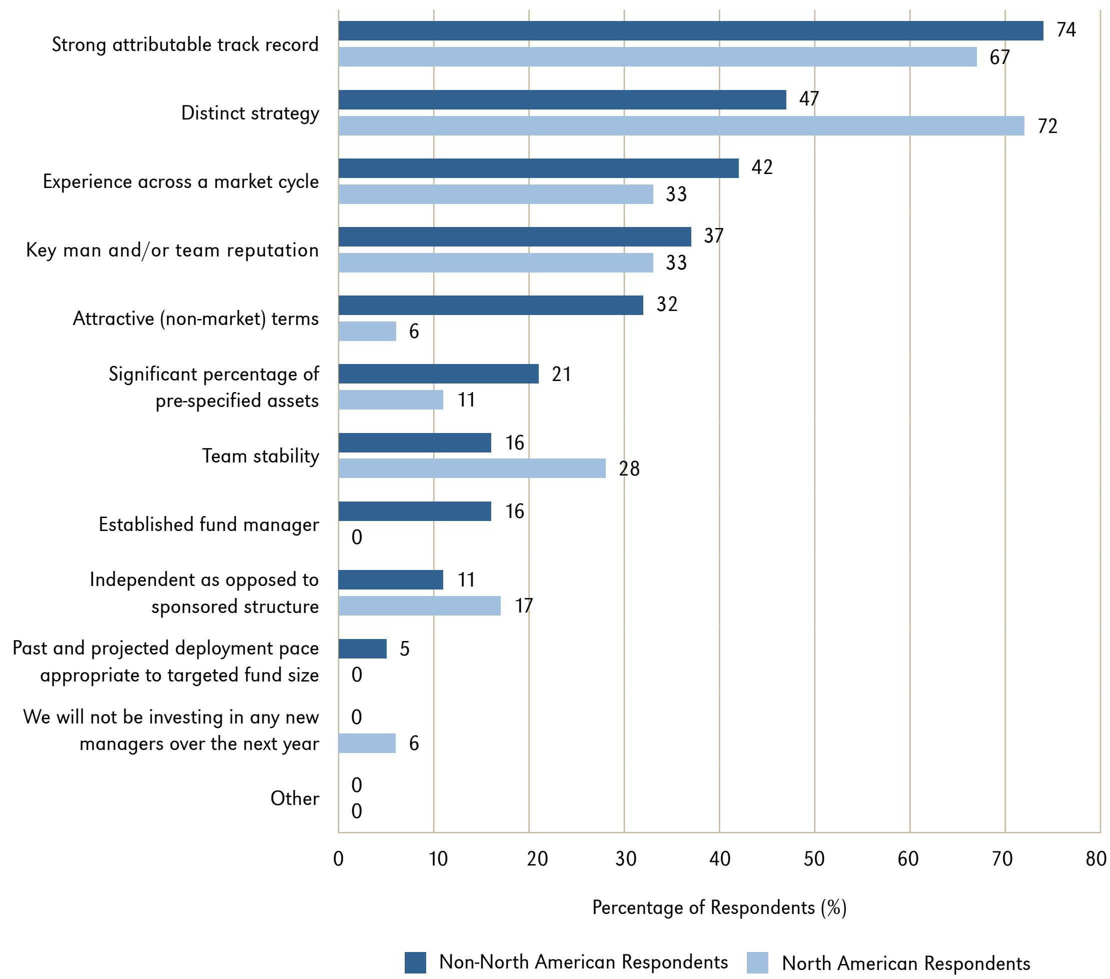


Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

- Investors from different geographies focus on different issues. North American investors were much more interested in funds with distinct strategies — their number one focus. Respondents outside of North America were more focused on the track record, experience across cycles, and attractive non-market terms (Chart XXVI).

Chart XXVI Key Characteristics of New Fund Managers

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



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

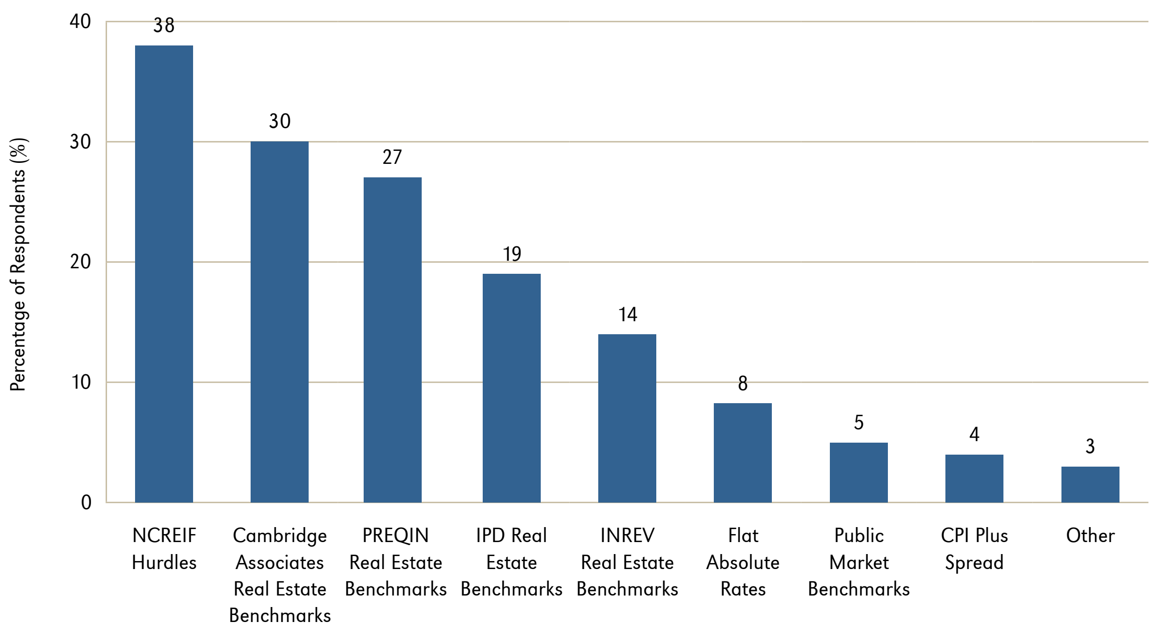
"North American investors were much more interested in funds with distinct strategies — their number one focus."

Benchmarking

- In reviewing the responses in Chart XXVII, it is obvious that several respondents use multiple benchmarks. NCREIF hurdles lead, though they are not dominant, and Cambridge Associates and PREQIN score well.
- Although not in the chart, for North American investors, NCREIF and Cambridge are much more important, with 55% of respondents using NCREIF hurdles. PREQIN is stronger outside of North America, with 42% of respondents using it.

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: 2019 Survey Results

Investor Fears and Concerns

- Investor's biggest fear, with 62% of respondents, was that we are nearing another cyclical market peak (Chart XXVIII). The fear of too much dry powder driving down future returns was a close second, with 59% selecting it. No other concern reached a level of note with a significant number of respondents.

- Last year the concern that increasing interest rates will negatively impact portfolio valuations was the third-ranked option with 47% of respondents concerned about it. This year that issue fell to fourth place, with only 24% of investors mentioning it.

- Table III presents a comparison of the top three fears from our 2008 survey, taken in the spring just before the GFC, compared to this year's survey. Increasing credit problems in mature markets was the largest issue by far in 2008. This year, the two top issues were either direct or indirect concerns about where we stand in the market cycle but notably not citing concerns on the credit front.

Table III What Keeps You Up at Night?

Top Three Responses

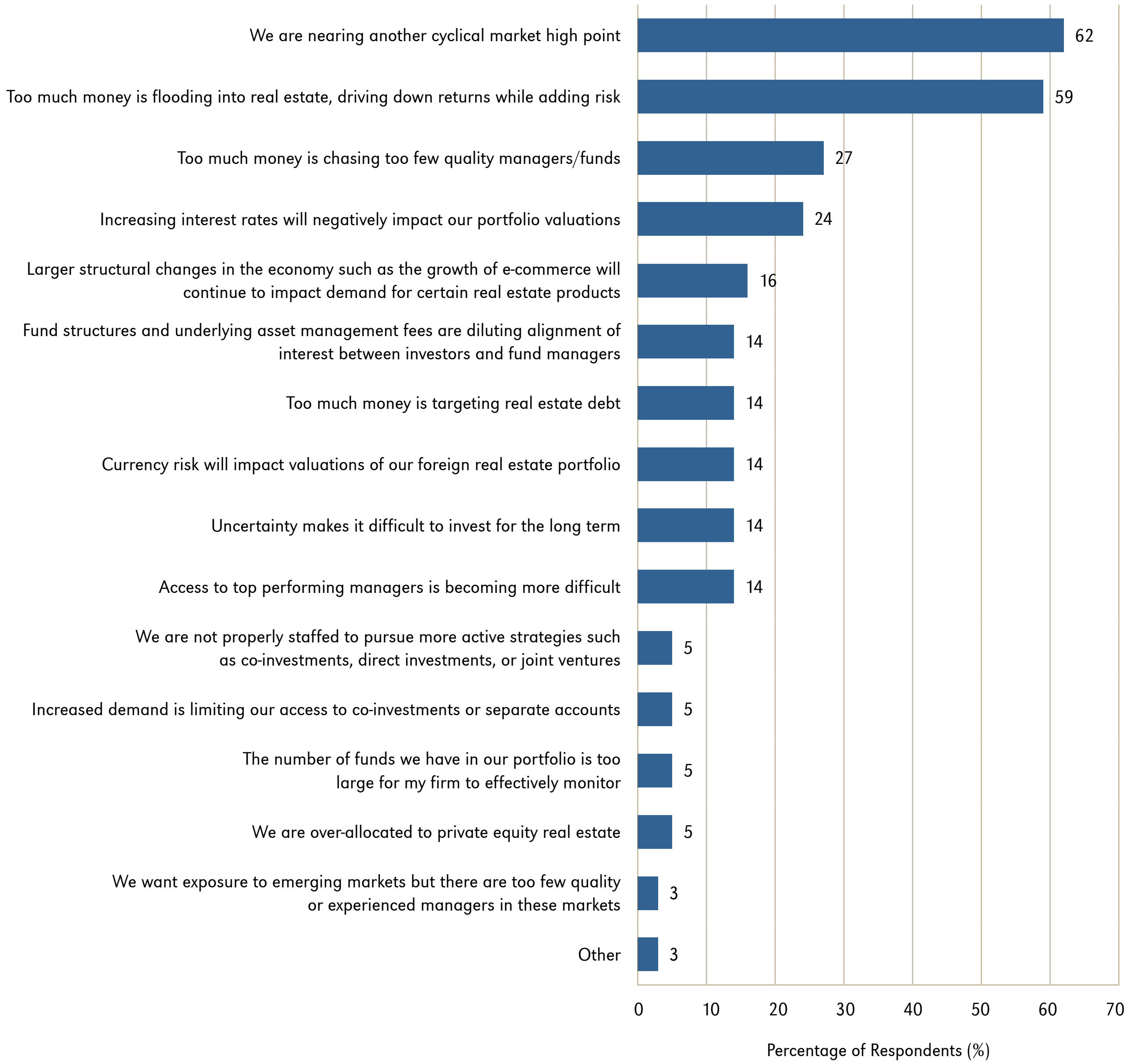
2008		2019	
Issue	**%**	**Issue**	**%**
Credit problems in Western or mature markets will dramatically impact performance	67%	We are nearing another cyclical market high point	62%
Capitalization rates will increase significantly impacting existing portfolio valuations	30%	Too much money is flooding into real estate, driving down returns while adding risk	59%
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	27%

Source: Probitas Partners' Real Estate Institutional Investor Trends: 2008 and 2019 Survey Results

"Investor's biggest fear, with 62% of respondents, was that we are nearing another cyclical market peak."

Chart XXVIII Greatest Fears

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



Source: Probitas Partners' Real Estate Institutional Investor Trends: 2019 Survey Results

Our View of the Future

We see several trends continuing or building in the market:

- ***More active strategies like direct investments, separate accounts, and joint ventures will increasingly be targeted by large investors.*** Investors continue to seek lower investment costs to enhance returns and are also looking for more control over portfolio construction. It is not typically an approach for smaller institutions that lack these resources. We expect large activist investors to increasingly pursue these strategies and deploy significant amounts of capital away from closed-end funds into these efforts.

- ***In an increasing split between smaller and larger limited partners, closed-end funds focused on value-added and opportunistic strategies will continue to attract smaller investors who lack the resources to invest directly.*** However, these investors are not blindly investing in funds. Many are concerned that we are at the top of the market with more downside than upside risk. They are very focused on manager selection, seeking managers with demonstrated ability to deal with adverse market cycles or those offering defensive strategies to hedge or capitalize on anticipated market volatility.

- ***Smaller investors still seek ways to moderate the cost of manager participation to secure the benefits of direct investing like their larger counterparts.*** One of the growing ways for them to do so is to co-invest alongside fund managers they have backed, as a more efficient way of enhancing returns. Though this approach is not without its own costs, we expect to see this activity grow as more fund managers offer co-investment as both a means of retaining fund investors and attracting new ones.

- ***There is broad concern about most emerging markets, though interest in China seems to be rebounding.*** Emerging markets broadly have never been a huge target for institutional real estate fund investors, but the past three years has seen a marked step back. Over this period the majority of respondents to our surveys have indicated no interest in emerging markets, though interest in China increased over the last year.

"Investors continue to seek lower investment costs to enhance returns and are also looking for more control over portfolio construction."

Real Estate Institutional Investor Trends: 2019 Survey Results

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