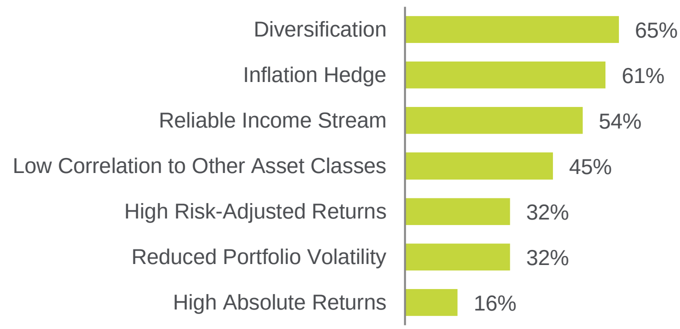
Institutional Investing in Private Real Estate: The Evolving Capital Raising Landscape

Why Do Institutions Invest in Private Real Estate?

Institutional investment in private real estate continues to be in high demand globally. Driving factors behind the demand relate to the asset class' ***low correlation to equity and bond returns, competitive risk adjusted returns, and in many cases, a stable income stream.***

For these reasons, private real estate assets under management have more than doubled since 2009, and in 2016 stood at $795 billion, according to research firm Preqin. Institutional portfolio allocations to real estate have also increased over recent years, with the average target allocation rising from 9% in 2011 to 10% in 2016.

Private Real Estate Investment Drivers



Source: Preqin

According to real estate advisors Hodes Weill & Associates, ***institutional allocations to real estate are expected to continue to rise***, as investors continue to look to real estate as a key part of their portfolio for diversification, attractive risk adjusted returns and reliable income generation.

Preferred Investment Sectors Within Real Estate

Source: CBRE Group Inc.

Which Real Estate Sectors do Institutions Prefer?

Office remains the top real estate sector for institutional investment globally, with multi-family a close second. However, CBRE Group Inc. notes that ***multi-family*** is the sector of choice for North American investors because of its ***defensive nature and the stability of its returns*****.**

Over the last 10 years, rental growth in multi-family has outperformed the majority of other real estate sectors in the U.S., with vacancy rates reaching 10 year lows and remaining stable throughout the economic cycle.

How Do Institutions Invest in Private Real Estate?

A substantial majority of institutional investors rely on third party asset managers for their real estate investments; approximately 94% of institutions globally have at least some of their investments managed by third parties, according to Preqin. This approach provides investors with ***flexibility and scalability in building diversified real estate portfolios***, where third party asset managers are able to utilize their local market knowledge and access a pipeline of deals, potentially in a more cost-efficient manner.

Starlight Multi-Family Asset (Austin, Texas)

Numerous options exist for institutions to invest through third parties, with key decision criteria including: ***amount of capital to deploy, desired portfolio diversification, risk tolerance, level of discretion and amount of control desired in the relationship with the third party asset manager.***

Two of the traditional structures available to institutional investors are commingled funds and joint ventures (JVs). A commingled fund (fund) typically has a large number of passive investors, with the asset manager having discretion over investment decisions such as acquisitions, dispositions, financing and asset management strategy.

Starlight Multi-Family Asset (Victoria, Canada)

In contrast, a real estate JV usually consists of a single investor in partnership with an asset manager, investing in either an individual property or a portfolio of assets. The investing partner is active in this scenario and usually has discretion over investment and asset management decisions, with the asset manager executing on the strategy.

How is Private Real Estate Investing Changing?

The private real estate industry is evolving rapidly across many fronts, as substantial capital continues to enter the asset class from institutional investors globally. Case in point, ***over $525 billion has been invested into private real estate over the past five years***, according to Preqin.

With this evolution, many institutions have become more knowledgeable and sophisticated in investing in this asset class, having gained experience in managing portfolios and achieving returns throughout the economic cycle. Consequently, an increasing proportion of institutional investors are now seeking alternatives to the traditional fund model -- more customized structures which provide them with ***greater transparency and control over key aspects of investment decision making***. For instance, Institutional Real Estate, Inc. notes that even though funds continue to be the preferred structure of investing into real estate globally, AUM allocated to them has fallen from 69% in 2015 to 57% in 2017.

In response to these changes in investor preferences, a small number of forward looking asset managers have started to offer ***innovative opportunities*** to institutional investors. One such innovation is the "club deal", which has risen in popularity and is becoming a more prevalent vehicle for private real estate investing.

"Over the next two years, club deals and JVs are expected to see the highest increase in use, as investors seek greater customization and discretion," according to an institutional investment survey by Pension Real Estate Association

Capital Raising Spectrum

Commingled Funds	Club Deals	Joint Ventures
High number of investors	Low number of investors (2-4)	Single investor
Smaller capital allocations	Large capital allocations	Medium-large capital allocations
Limited discretion and involvement	High discretion and involvement	Medium-high discretion and involvement

What are Club Deals?

Club deals are a ***hybrid between a fund and a JV***. This type of partnership typically contains a handful (e.g. two to four) of sophisticated institutional investors, who pooled together are able to fund large amounts of capital. Together in a club deal, these investors gain access to a larger and more diversified set of deals, compared to investing in a JV. Club deal investors are actively involved in the acquisition process, with the partnership often having detailed acquisition criteria subject to investors' approval. Similar to a JV, after a property is acquired, major decisions are typically also subject to club investors' approval. Thus***, establishing acquisition and investment parameters is key***, as this constructively directs the partnership in the process of building and managing the portfolio.

Starlight Commercial Asset (Toronto, Canada)

Many institutional investors are also attracted by the opportunity to **invest alongside a small number of like-minded investors who are also committing substantial amounts of capital.** This is in contrast to being part of a fund with a large number of investors that they did not have input in selecting.

Club deals thus require a solid alignment of interest and a great degree of trust between the asset manager and investors, as well as within the investor group to avoid confusion and deadlock in the investment process.

Club Deal Success Criteria

- Similar access to capital and speed of decision making process
- Aligned incentives
- Similar investment horizon and return objectives
- Agreement on investment parameters
- Trust

Who is Best Suited for Club Deals?

Similar to JVs, interest in investing into club deals varies significantly depending on the size of an institution. Not surprisingly, ***these structures are particularly popular with larger institutional investors***, as smaller ones may not be sufficiently staffed or have the in-house capabilities required to initiate and monitor these investments. According to Hodes Weill & Associates, approximately 70% of larger institutions are interested in investing in these vehicles, compared with only 30% for smaller institutions.

Institutional investment demand and portfolio allocation to private real estate continues to trend upward at a time when institutions are becoming more knowledgeable and sophisticated in investing in this asset class. Even though traditional funds remain the predominant structure for institutions to invest into real estate globally, these investors are increasingly seeking customized structures to provide them with greater transparency and control over key aspects of investment decision making. ***Structures such as club deals are not for every investor in every situation, however can be very effective when investment partners and the asset manager are aligned.***

How Does Starlight Transact Across the Capital Raising Spectrum?

Starlight has ***experience in transacting across the entire capital raising spectrum***. For a particular private real estate strategy, the selection of the specific structure is determined and segmented based on the investment needs of our various investors. To ensure alignment of interest, Starlight co-invests a significant amount of equity along its investors.

About Starlight Investments

Starlight is a Toronto-based, privately held, full service, real estate investment and asset management company driven by an experienced team comprised of over 120 professionals. Starlight currently manages $7.5 billion of multi-family and commercial properties through funds, JV's and club deals. Starlight's portfolio consists of approximately 35,000 multi-family units across Canada and the U.S. and over 4.6 million square feet of commercial properties. For more information visit www.starlightinvest.com and connect at www.linkedin.com/company/starlight-investments-ltd-.

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