Brookfield

INSIGHTS
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REAL ESTATE

Opportunities Abound for Real Estate Secondaries

The growth of capital—both raised and deployed—by private equity real estate funds since the Global Financial Crisis has been impressive. More than $1 trillion has been allocated to such funds in the last 12 years.[1] And both the growth rate—and the resulting quantum—do not appear to be slowing down.

As primary capital investments increase, a natural corollary market tends to develop in the form of secondary transactions. Simply put, secondaries are investments made in existing assets, structures or situations that bring fresh equity, reset an investment's clock and re-align its ownership.

Real estate is an attractive corner of the secondary market, particularly given the advent of transactions known as GP-led recapitalizations.

Once seen as a way to recapitalize assets that were difficult to sell, these transactions are now recognized by general partners (GPs) as an opportunity to hold onto their best assets. And for investors in these secondaries, GP-led recapitalizations often provide an opportunity to gain exposure to high-quality assets that were previously out of reach.

Indeed, real estate secondaries AUM reached 2.7% of all real estate AUM at the end of September 2020—up from less than 1% at the end of 2013.[2] And we expect that ratio to continue to increase as more GP-led recapitalizations hit the market. Moreover, the investable universe is vast because almost any commercial real estate asset is a candidate for a secondary transaction, not just those in funds.

Yet, it's important to remember that new opportunities can bring new complexities. As GP-led recapitalizations are quickly becoming the future of the real estate secondary market, we believe that making the most out of these opportunities will require specialized experience and expertise in owning, operating and investing in real estate.

The Growth of Real Estate Secondaries

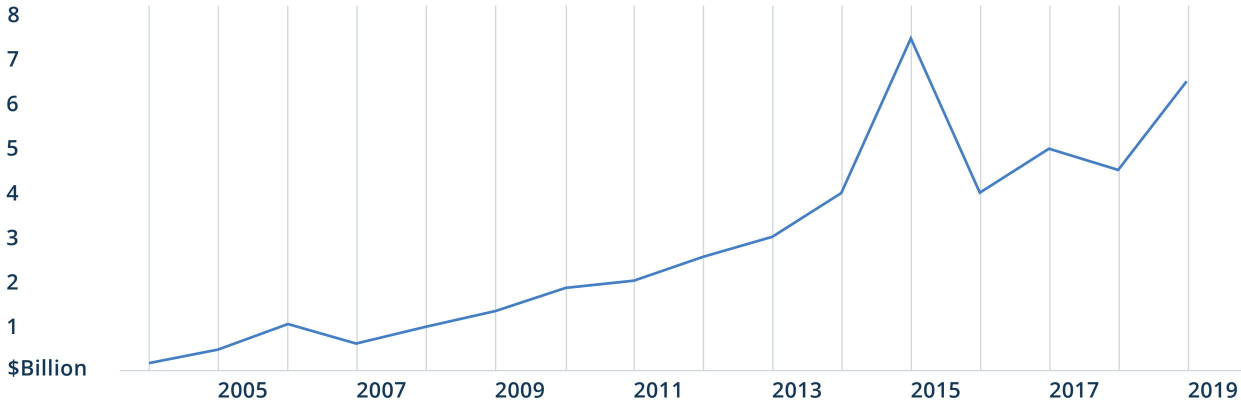
While real estate is largely illiquid and intended to serve as a long-term investment, private funds typically have lives of 7-10 years. This timing mismatch can create opportunities in the secondary market.

Transaction volume in real estate secondaries has experienced tremendous growth as both limited partners (LPs) and GPs look for flexibility and liquidity in managing their private market investments (see Figure 1). Assets under management for real estate secondary funds almost tripled between December 2016 and June 2020, from $9.3 billion to $27 billion.[3] Today, real estate represents approximately 5% of the overall secondary market, which continues to be dominated by private equity assets (see Figure 2).

In the wake of an extended period of active real estate fundraising, the stage appears set for significant opportunities in secondaries for the foreseeable future (see Figure 3). As these funds near the end of their terms, many GPs may be looking to recapitalize. And since any real estate asset could potentially be a recapitalization or secondaries candidate, the market's potential size is massive.

FIGURE 1

Transaction Volume Has Grown Significantly for Real Estate Secondaries

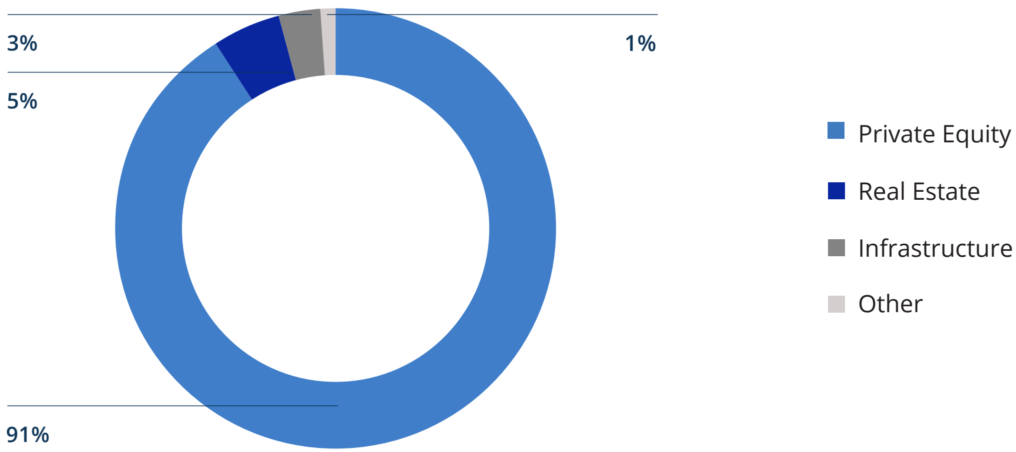


Source: Greenhill, Evercore, June 2020.

FIGURE 2

Private Equity Continues to Dominate the Secondary Market

2020 secondary transactions



Source: Setter Capital "Volume Report FY 2020."

FIGURE 3A

Strong Fundraising Has Fueled Real Estate Secondaries

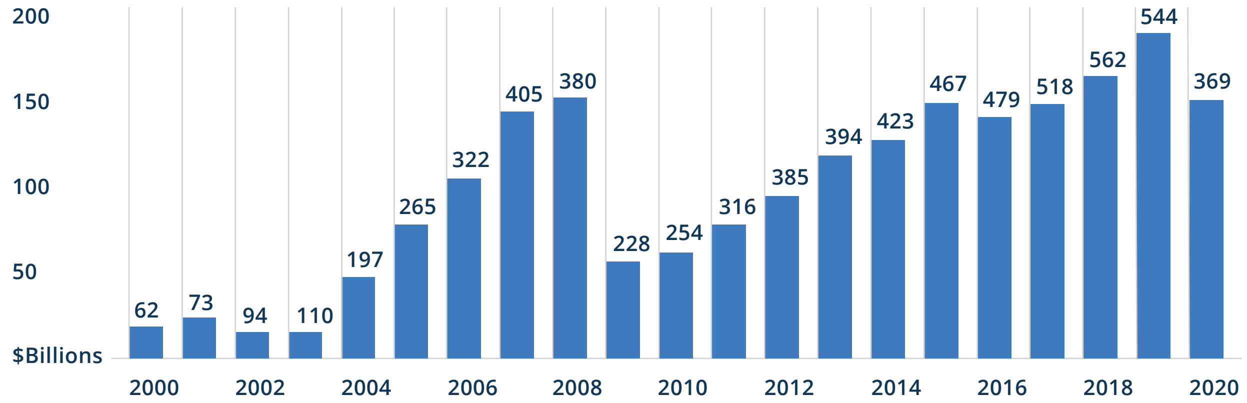
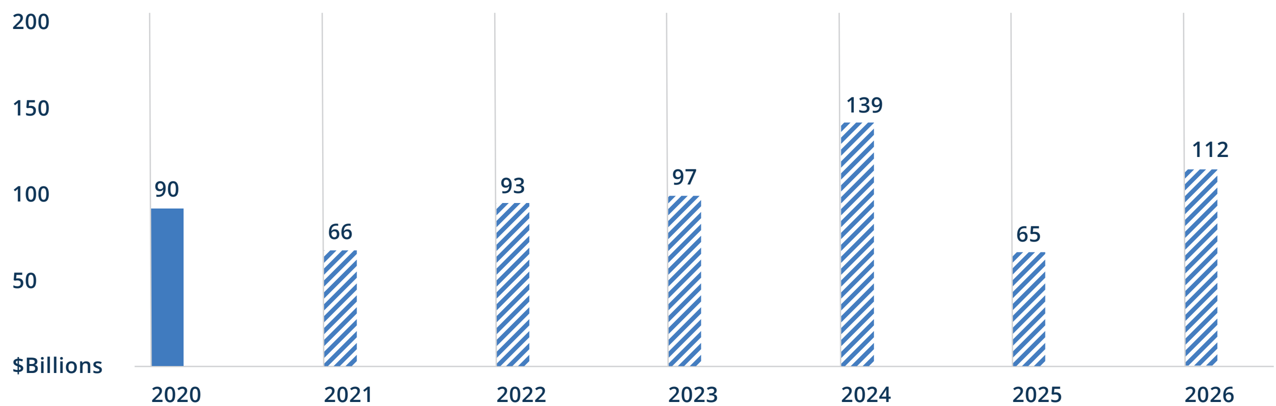


FIGURE 3B

Projected Real Estate Fund Maturities



Source: Preqin; Landmark, Park Madison, Brookfield projections.

The Rise of GP-Led Recapitalizations

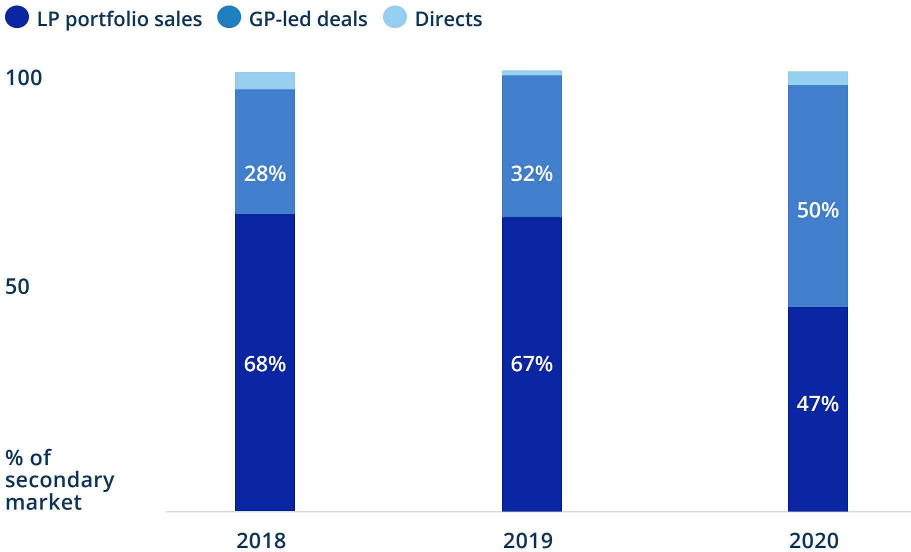
LP-led deals are the more traditional type of secondary transaction. They involve the sale of a fund interest from an LP that wants to liquidate prior to the fund's termination. Traditional secondaries provide those LPs with liquidity (for example, to meet capital constraints), allow them to lock in gains early and/or give them a way to reduce their over-allocation to an asset class.

Investors that purchase those secondary interests, on the other hand, can potentially gain access to high-quality assets at attractive valuations, J-curve mitigation, higher current income, shorter payback periods and greater diversification. Exposure to secondaries can also broadly augment a defensive, risk-adjusted approach to investing in real estate.

GP-led transactions are a more recent phenomenon. GP-led is a broad category that encompasses a number of ways in which a GP can generate liquidity for itself or its investor base, including recapitalizations, tender offers and spinouts.

FIGURE 4

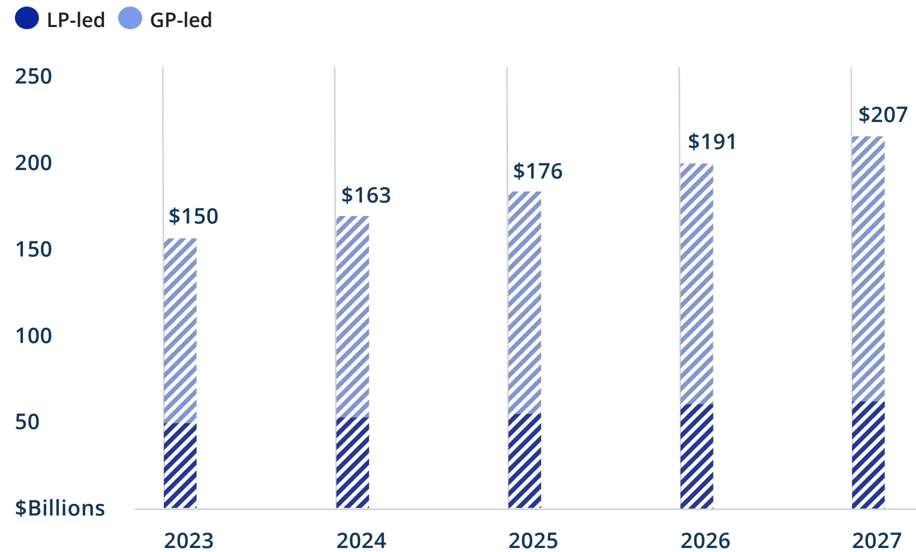
GP-Led Has Taken a Growing Share of the Secondary Market



Source: Evercore.

FIGURE 5

GP-Led Growth Appears Set to Continue



Source: Brookfield Asset Management.

For GPs, engaging in a secondary transaction can confer several benefits. It can allow them to:

- Accelerate liquidity and lock-in gains for their LPs
- Add strategic and/or long-term investors to their investor base
- Retain many of their best assets while realizing additional upside
- Obtain fresh capital for new or follow-on investments
- Deliver more customized solutions to their LPs

GP-led transactions can also provide several benefits to both primary and secondary LPs, such as opportunities to:

- Reset the fund's economics to better align the GP's interests with those of the LPs
- Realize returns earlier in their investment or lock-in gains
- Generate liquidity
- Manage or re-balance their portfolios
- Target high-quality assets that are difficult to buy directly
- Roll-over into the GP-led recapitalization

As a result of these benefits, GP-led transactions have become a more prominent share of the overall secondary market in recent years. GP-led recapitalizations are estimated to represent 50% of the overall secondary market in 2020, up from 32% in 2019—a trend we expect to continue (see Figures 4 and 5).

A Hypothetical GP-Led Recapitalization

A GP is managing a diversified fund portfolio of commercial real estate assets.

The portfolio is considered high-quality for several reasons:

- The assets are more than 90% occupied, with an approximate five-year weighted-average lease term
- The expected average cash-on-cash yield is in the high single digits
- The tenants are high-quality and operate in strong industries
- Cash flows are stable with mark-to-market upside in rents
- The assets are in a city with strong rent growth, low vacancy rates and other attractive characteristics

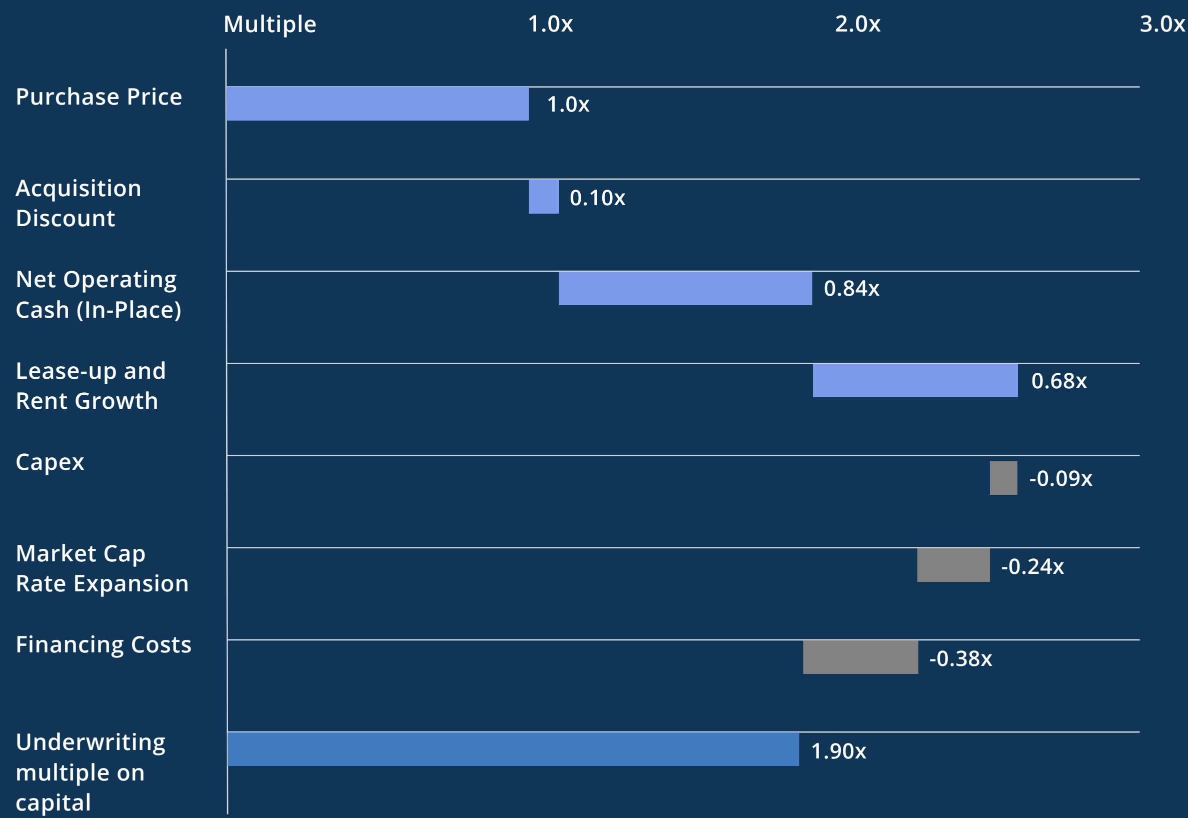
The fund is about midway through its term—the business plan is partially executed but the fund is low on dry powder. The investment still has significant unrealized growth, but the LPs are seeking liquidity. Meanwhile, the GP sees potential for additional upside and wants to obtain follow-on capital to further develop the assets. So the GP then turns to the secondary market.

After negotiating financing and other terms, the GP enters into an exclusivity agreement with a strategic long-term investor. Through the agreement, the investor will acquire up to 95% of the portfolio from existing LPs while the GP commits 5% to the continuation fund. The GP's incentives are also reset based on current net asset value and the current return profile of the investment.

Going forward, the GP will be able to continue to manage the assets, receiving the capital it needs to realize additional upside, while adding a strategic long-term investor to its investor base. The secondary investor, meanwhile, is able to gain exposure to these high-quality assets with a strong alignment of interest with the GP.

FIGURE 6

A Path to Value Creation



Source: Brookfield Asset Management.

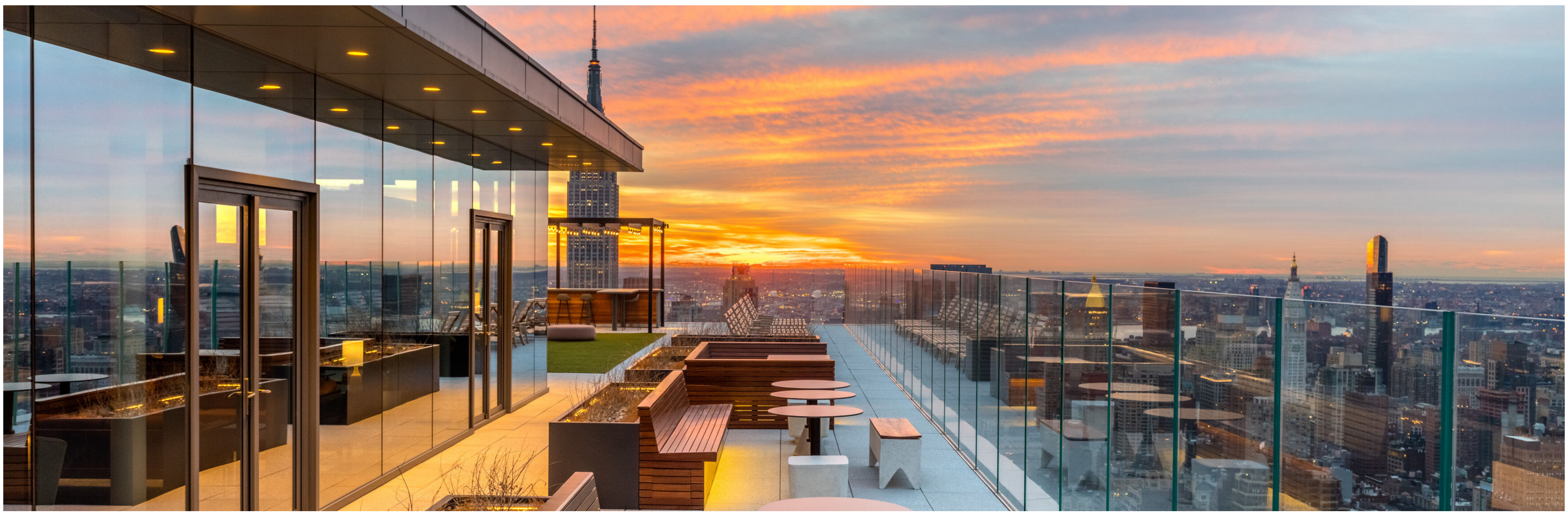
Why Now?

Macro events—such as the Global Financial Crisis—tend to spur even greater secondary market activity. The COVID-19 crisis appears to be the latest catalyst, pushing GP-led recapitalizations to the top of the real estate secondary market as many GPs have had to change their exit plans for hospitality, retail and office assets.

However, the best answer to the question of "why now" may be an evolution in thinking among GPs. While GPs used to seek to recapitalize only the worst assets, now they're looking to do so mainly for the best. In other words, even when markets are especially strong, GPs may want to bring in new capital and give themselves more time to work with assets that have significant additional value creation potential, especially in the context of portfolios that took years to aggregate.

Currently, we are seeing secondary transactions of all types arise for many reasons. Some LPs may simply be looking to re-balance their portfolios—for instance, to reduce their allocation to real estate private equity. We have also seen secondaries arise as event-driven opportunistic investments, which may involve LPs (often high-net-worth investors) that invested in a real estate fund five or six years ago and are looking for an opportunity to exit. In many cases, they are willing to sell, often to an institutional investor, at a discount to intrinsic value.

Finally, opportunities are also arising in situations where COVID has affected business plans, causing a disruption to the LP base, strategy or capital allocation. Here, these funds are seeking institutional capital, deep industry relationships, and structuring or operational experience to help them implement their business plans.

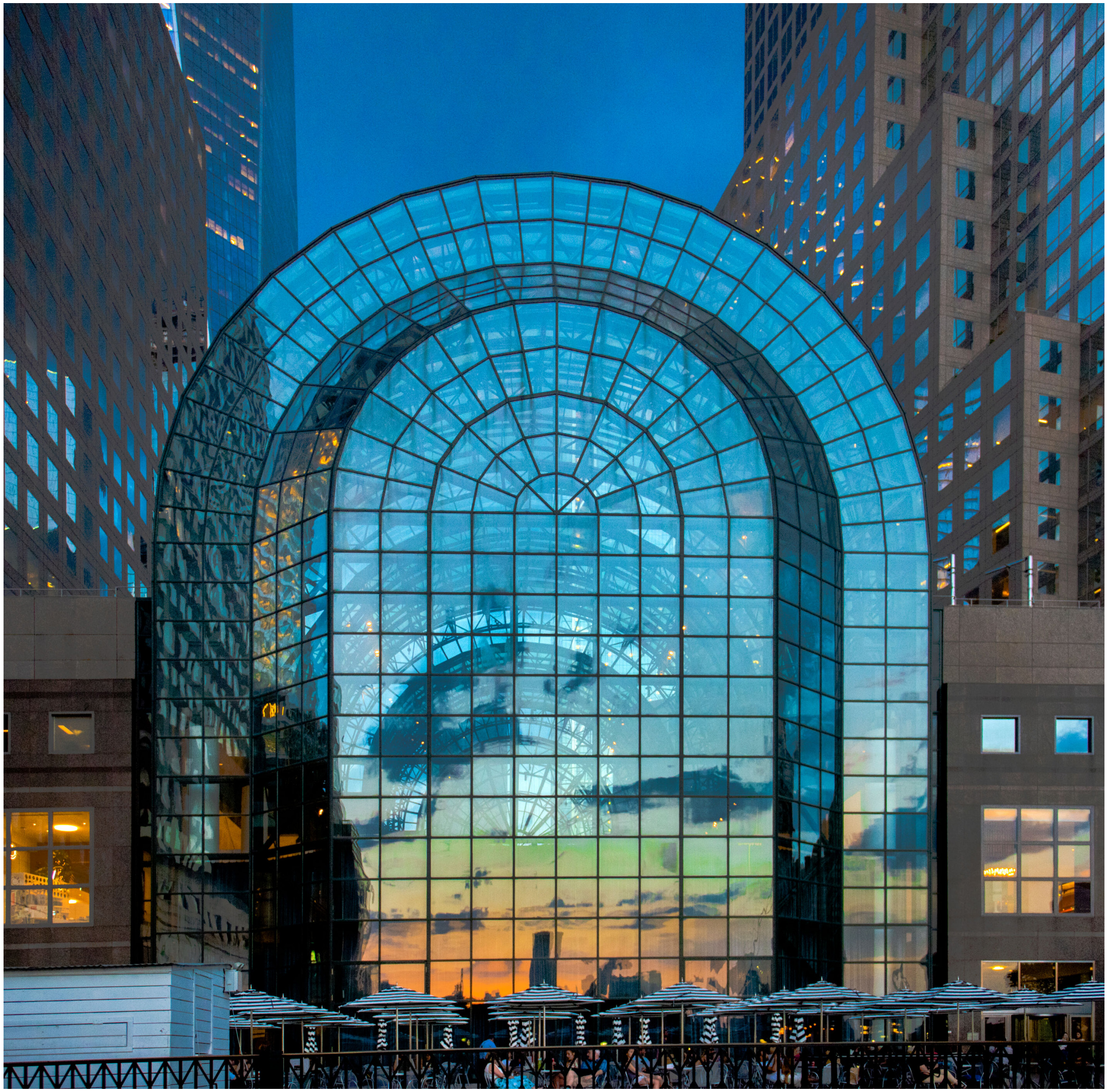


Managing Complexity

The types of real estate secondary transactions vary widely. They can involve the acquisition of privately held assets (whole or partial) from existing institutional or high-net-worth investors or the purchase of real estate fund interests.

And they can employ a wide variety of legal structures, including commingled closed-end funds, separate accounts, joint ventures, REITs, operating companies and open-end funds. Therefore, comfort and experience with complexity are an advantage for those who wish to invest in secondaries.

The rise of GP-led recapitalizations has also highlighted a need for more specialized partners in these transactions. For instance, these transactions tend to involve a single asset or are otherwise highly concentrated portfolios. Investors that have the underwriting capabilities and investment expertise to be able to perform the necessary due diligence can likely add value to the relationship through the remaining life of the investment.



A Long Runway Ahead

While the vast majority of secondaries are in private equity, areas like real estate and infrastructure are growing. This, along with their potential benefits—such as accelerated liquidity, locked-in gains and value creation opportunities—means we believe there will be a long runway for the secondaries market from here. This is especially true for the GP-led segment.

As the market becomes more complex, we believe investors should consider newer transaction types that allow them to gain access to high-quality assets. With the potential benefits that GP-led recapitalizations and other secondaries can bring, we believe the best approach is to remain focused on due diligence.

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[1] Preqin for the period starting January 1, 2008 through December 31, 2019.

[2] Preqin.

[3] Preqin.

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