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Rising to the Top

The reasons private equity real estate funds are trending upward.

by Brian Ward

The commercial real estate industry is experiencing strong growth in debt funds and a boom among private equity firms. Within the past year, multiple new real estate debt funds have either closed or still are raising billions of dollars.

The four largest publicly traded private equity firms — Blackstone, KKR & Co. L.P., the Carlyle Group, and Apollo Global Management — are reporting their biggest quarterly increase in assets since the third quarter of 2013. The four firms now manage $921 billion in assets — up 6.5 percent from second quarter 2017.

These trends affect the securitization market by allowing a larger spectrum of investors with access to an asset class that requires a long-term commitment, but that generally offers lower volatility, higher risk-adjusted returns, and protection from inflation.

A large group of investors always chases the next big asset class or the next quick, easy return, with the expectation of higher yields. In the late 1990s, it was tech stocks, particularly through IPOs. Prior to the Great Recession, it was real estate, mortgages, commercial mortgage-backed securities, and derivatives.

But the rise of debt funds is a longer-term trend that has been building steadily as commercial real estate capital shifts from banks and securitized vehicles to nonsecuritized, effectively nonregulated, or rather market-only regulated, forms of liquidity.

The absence of Lehman Brothers, Bear Stearns, and the true investment banks of the past is helping to drive this increase in private equity coffers. Regulated cash requirements have largely persuaded traditional banks to stay in their lane and leave alternative assets to the other guys.

Alternative Investments

Private equity fund managers are investing the cash those investment banks would have deployed in alternative investment

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markets. Without changes to the current regulatory environment, traditional banks will continue to limit their exposure to commercial real estate.

Traditional banks still can be expected to provide balance-sheet loans on a recourse basis to their customers, but they ultimately will adopt a leaner, less back-office-intensive business model. Similarly, banks will continue to play a role in CMBS and the overall securitized market, but their business will remain relatively minor in comparison to the broader capital needs of the market.

As a result, private debt and private equity will see outsized growth of capital for deployment. More equity exists in today's deals than during the last cycle, and the markets are pricing the risk correctly for potential future movements in both short-term and longer-term interest rates.

As stated by lenders, leverages and coverage ratios seem to be holding. However, the devil is in the details of how the lenders are underwriting income and expense growth, as well as residual cap rates. It is evident that the more capital that exists in any space, the more underwriting standards will be compromised to compete for good deals and borrowers.

The rise of established real estate developers acting as lenders through debt investments is part of this evolution. This is not a veiled attempt at a loan-to-own strategy, but rather a way for developers to satisfy too much demand from interested partners compared to the number of viable development deals available.

It also may show developers' desire to expand to new areas along the risk curve. In any case, this is preferable to them trying to force too many new deals or ever-risky transactions simply to remain productive.

As investors navigate the first quarter of 2018, they should call on the expertise of fund managers who are closely monitoring where private equity funds are flowing in U.S. and global real estate. Most important, investors need to determine where private equity will flow next.

For example, multifamily currently is the favorite asset class, followed by industrial real estate. Investment in the industrial market is logical, as the uptick in online retailers is driving a repurposing of facilities and development of new warehouses and distribution centers.

While private equity interest in commercial real estate investing continues to build, also look for new opportunities to arise as asset management firms become full service and innovative loan structures are introduced.

Brian Ward is CEO of Trimont Real Estate Advisors.