



Challenges and Opportunities For Real Estate Private Equity Funds

REAL ESTATE PRIVATE EQUITY FUNDS WITH dry powder are actively positioning themselves to take advantage of opportunities to buy the estimated \$2 trillion in distressed assets, non-performing commercial and residential loans and CMBS.

According to Real Capital Analytics, the number of distressed assets has grown exponentially since late last year. The first quarter of 2009 alone saw another 1,372 properties worth more than \$25 billion added to the already-burgeoning number of distressed assets, bringing the total figure close to 4,000 properties, worth \$73 billion.

In addition, there is an estimated \$1.4 trillion of commercial real estate debt coming due in the next four years. The combined effects of declining property values and the general deleveraging associated with this trend could potentially result in an equity shortfall of \$400 billion to \$500 billion over the next five years.

Given the declining economic fundamentals in the residential and commercial markets, along with the end of once-plentiful and cheap debt and equity capital, it's no wonder that the challenges facing many real estate private equity funds are formidable.

Raising capital has become increasingly difficult in today's market. Public and private pension funds, endowments and high-net worth individuals—the most significant investors in private equity funds—are facing their own liquidity issues and remain concerned about the declining values of real estate and the resulting decreases or elimination of cash distributions. Steep losses in the global public equity markets has also caused many institutional investors to be over-allocated to real estate—the so-called denominator effect. As a result, many funds are now settling for lower capital raises with longer periods. Numerous other funds will, or have already, abandoned their fundraising efforts altogether.

Any funds, in fact, that have invested in highly leveraged assets over the past three years are facing significant legacy issues that will severely impact their ability to raise capital, do deals or simply survive. Funds facing these legacy issues are currently refocusing their strategies and efforts toward working out these assets with lenders and repositioning them in an illiquid market.

Faced with evaporating cash distributions, ending capital calls and falling portfolio values, investors with liquidity are carefully evaluating their relationships with fund managers in terms of their performance, fees, transparency and control of assets.

The continuing fallout from the “Madoff effect” and the threat of newly proposed SEC regulations, combined with the President's budget proposal to tax carried interests as ordinary income versus capital gains, has further exacerbated both investors' and fund managers' anxieties.

There are significant trends to track as we begin to see some faint signs for optimism. The US will once again take the lead in attracting global capital. In 2008, approximately one-third of all global capital was targeted for US investment. That percentage will increase this year and next.

Newly formed and existing funds with dry powder and little to no legacy issues will continue to sit on the sidelines eagerly anticipating distressed opportunities as the bid-ask spread narrows—even without the highly leveraged model they used to rely on to boost their returns.

Once troubled assets are recycled through the economy and the capital markets normalize, private equity will inevitably be put into play.

The Treasury and Federal Reserve programs, PPIP and TARP, have not been effective in moving so-called toxic assets off banks' balance sheets and into the private markets. These programs will hopefully be further modified in order to successfully jumpstart the flow of transactions.

Make no mistake—private equity will invariably remain a substantial capital source for property sales. Once troubled real estate assets and loans are recycled through the economy and the capital markets normalize, private equity will inevitably be put into play.

The question is: who will be left standing with capital and the know-how to take advantage of what many investors believe will be a once-in-a-generation—or perhaps historic—opportunity to create wealth. ♦

The views expressed in this column are those of the author and not necessarily REAL ESTATE FORUM.

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