



What's ahead for real estate funds?

Trends to track in 2017

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When real estate fund leaders look at the coming year, they see plenty to smile about. A healthy economy, strong fundamentals, and ready access to financing and capital make 2017 appear to be a great year for the fund business.

But what about when they look deeper? How will the recent rise in interest rates, the Trump administration, and other uncertainties impact investor perceptions of U.S. markets and investment opportunities and performance?

In January 2017, KPMG LLP (KPMG), in collaboration with Shelter Rock Capital Advisors (Shelter Rock), brought together distinguished limited partners (LPs), general partners (GPs), and industry specialists to address these questions.

We've summarized highlights of the program in this paper. Find out where institutional investors see the best opportunities for safe, steady returns; where owners and managers plan to deploy their capital in the year ahead; and other need-to-know facts and insights for real estate fund professionals in 2017.

The real estate boom continues

A popular question in the real estate industry is how much longer the historically long up-cycle can last. Consensus seems to be that it will continue for the time being. In an informal survey of audience members conducted live during the program¹, 76 percent of participants said their expectations for the U.S. real estate business in 2017 were about the same or improved as compared to 2016. "We thought the market had peaked in late 2015, and that in 2016 we were close to the end of the runway, but now we see the economic cycle being extended," said Sean Bannon, managing director of Zurich Alternative Asset Management. Added Phil Marra, KPMG's national real estate funds leader: "Real estate returns are doing better than the bond market, stock market, and most other alternative investment classes. When risk-adjusted, investors are more than happy with the returns they see from their real estate portfolio."



Expect a seller's market

Investing is a round-trip ticket, and 2016 was a pretty good year to sell. With prices high but starting to plateau, that should continue in 2017. Many investors are finding they don't need to put up a discount to sell a portfolio. Said Judy McMahan, who manages real estate for the pension trust for UPS Group: "Buy low, sell high worked in 2016—we wanted to sell while there were buyers."

Investors are increasing focus on exit potential

While institutional investors may not be underwriting an immediate downturn in 2017, they are exercising restraint. Many investors are mitigating risk by concentrating on lower-risk assets and markets with high exit potential and strong cash flow, entering vehicles at discounted basis to market value, and pursuing strategies that will perform well in down markets. "Our theme is patience and caution in portfolio construction," said McMahan. "You always have to think about your exit and liquidity and basis when you invest your capital."

Debt investing is on the upswing

Searching for secure high yields, more investors may turn to debt investing. Debt instruments on operating assets generally pay a good current return from day one of the investment. In the current environment, debt may be able to be deployed faster than equity investments, which helps investors get money to work faster and reduces their allocation lock-up because of unfunded commitments. But investors warn that caution is paramount. "Make sure you know the leverage profile of what you're investing in," said Bannon.

¹ Methodology: KPMG conducted an online poll of live audience participants at a Real Estate Fund Trends event in New York City on January 17, 2017. Attendees were professionals in the real estate fund space—investors/LPs, real estate fund managers/GPs, owners/operators, and service providers.

Fund-raising is healthy

While there has been a slowdown in capital-raising compared to last year's high-water mark, the real estate sector should still continue to see more capital flowing in. "We're seeing lots of interest and a plethora of capital available for sponsors with strong track record performance," said Saul Lubetski, vice chairman of Harbor Group International.

Record levels of dry powder are available

Unused real estate fund cash reserves waiting to be invested have been steadily growing since 2012, reaching a current peak of \$239 billion, according to research by Preqin. This dry powder is especially concentrated in value-added and opportunistic funds—partially due to strong fund-raising, but also because those funds are not as readily able to deploy their capital as other types, such as debt funds².

There is room for small funds to compete

Preqin research shows that first-time funds are generating 5 percent to 10 percent greater returns, and investor attitudes towards them are improving³. As bigger deals are hard to find, sharpshooting small funds may find success in 2017. "While the big are getting bigger, there is still room for smaller funds if they can deliver alpha," said Marra.

Fundamentals could drive the business

According to KPMG's 2017 Real Estate Industry Outlook Survey, more than half (52 percent) of real estate executives believe improving real estate fundamentals will be a major driver of revenue growth—a 12-percentage-point jump from the 2016 survey⁴. "We aren't seeing new record highs on rents or capital-raising, but fund managers still feel pretty good," said Marra. "They feel they will be able to generate additional cash flow out of their assets."

Past performance and transparency matter most

GPs said a strong track record is often what sets sponsors apart in the eyes of investors. Brookfield is usually the largest investor in its own funds for that reason, according to Cristiano Machado, senior vice president at the asset manager. "We invest our own capital alongside investors," he said. Investor due diligence is also becoming increasingly rigorous, with GPs challenged to meet demands for real-time, detailed financial information. "Keeping investors informed is the single most important part of my job," said Lubetski.

America is still the best place for your money

Sixty-four percent of audience members polled expected foreign investment in U.S. real estate to moderately or significantly increase in 2017. According to research by the Association of Foreign Investors in Real Estate, New York has far and away eclipsed London as the top-ranked



global city for real estate investment, and Los Angeles, San Francisco, and Washington, D.C., also make the top-8 list⁵. Although there may be a "pause" as the Trump administration settles into office, we should continue to see global investment flowing into the United States.

Secondary markets are hot

Investors are beginning to look beyond the traditional top six U.S. coastal markets. They are targeting areas where property is less expensive and brings higher returns, and also offers the opportunity to expand the pipeline and diversify the portfolio. "We're finding very durable income-generating opportunities in smaller markets like Austin, Minneapolis, Salt Lake City, Nashville, and Charlotte," said Bannon. Certain urban characteristics are especially appealing. "I think the ability to appeal to a younger demographic will drive real estate investing over the near term," said Marra.

Demographic data favors single-family housing

Demographic shifts point to opportunities in single-family housing, given the huge population subset aged 23–32, the ideal time to form households. In addition, housing supply is at historic lows, while prices are high⁶. "We especially like rentals because mortgage credit is still limited, and, with student loan debt high anyway, young people might not want a mortgage even if they are approved for one by the bank," said Sandeep Bordia, head of research and analytics at Amherst Capital Management. "Single-family home rental may also be a preferred option for families that have outgrown two-bedroom, multi-family complexes but don't have enough savings for a down payment to purchase," Marra added.

² Real Estate Spotlight, December 2016, Preqin.

³ Preqin, January 2017

⁴ Real estate expansion lives on: 2017 Real Estate Industry Outlook Survey (KPMG, January 2017)

⁵ 2017 Foreign Investment Survey, Association of Foreign Investors in Real Estate

⁶ SNL Financial, NAR: 2016 existing-home sales in the US highest in a decade, January 25, 2017

Student housing is a popular niche

More GPs may buy private student housing assets in 2017, a niche which has favorable demographics behind it. There are more and more students enrolled in college, but not enough affordable campus or off-campus housing to go around. "Student housing is somewhat resilient to an economic downturn as unemployment usually creates more enrollees," said Sanjay Yodh, head of capital markets at Candlebrook Properties.

Interest rate hikes won't have a major impact

More than half of participants polled at the event (56 percent) said interest rate changes would have no impact on real estate prices or that prices would only modestly decline by the end of 2017, which bodes well for the real estate business. Capitalization rates for real estate are hovering close to 7 percent, according to research by Real Capital Analytics⁷. With these solid returns, there appears to



be a cushion to absorb the higher interest rates announced by the Federal Reserve in December 2016.

Tax reform is still a question mark

With Republicans controlling the White House and both branches of Congress, things are lining up for possible tax legislation over the next 12–24 months. Given current GOP thinking, any tax reform bill would most likely be designed to lower rates, simplify the tax code, stop inversion, and broaden the base. But according to Jim Sowell, principal of KPMG's Washington National Tax practice, and Peter Furci, partner at Debevoise & Plimpton, the ultimate bill—if passed—will probably be substantially changed from the current proposals on the table: Trump's high-level plan and the House Republican "Blueprint." Depending on how the details play out, the impact on the industry and even the macro economy remains to be seen, but real estate owners and investors should pay special attention to rules in proposed legislation related to tax rates, property expensing, deductibility of interest, international rules (including changes to the Foreign Investment in Real Property Tax Act provisions), and possible application of reasonable compensation concepts to partnerships, which could affect carried interest.

⁷ Real Capital Analytics, January 2017



These track-worthy trends in 2017 are a mix of opportunities and uncertainties. They highlight both the overall strength of the real estate fund industry, but also some potential issues that could crack the foundation. Based on the perspectives shared at this event, investors and managers who invest cautiously but creatively, with the right balance of risk and reward, should be able to build a solid future for their businesses.

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