# Gusts of change propel real estate funds

**Fighting the headwinds and riding the tailwinds in 2018**

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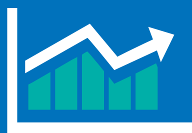


# The U.S. real estate market has long been one of the strongest in the world. A wide variety of attractive opportunities are available and everyone seems to want a piece.

**But that's not the whole story. Numerous forces are causing investors to look to new frontiers and owners to change how they operate and deploy capital, including record levels of dry powder, high competition for the best assets, low availability of properties with appropriate risk-adjusted returns, shifts in foreign investment, and the new environment brought about by tax reform.**

**On January 11, 2018, KPMG LLP and Shelter Rock Capital Advisors brought together distinguished limited partners, general partners and industry specialists to examine recent trends in U.S. real estate and their ramifications on the business strategies of fund managers, institutional investors, real estate developers and service organizations. In this paper, we share insights from the "Real Estate Fund Trends" event to help the real estate fund industry understand evolving challenges and take advantage of emerging opportunities in the coming year.**

# Positive outlook despite fund-raising slowdown

Without a doubt, real estate fund raising is slowing. There was substantially less capital raised in 2017 as compared to 2016.[1] However, declining fund-raising numbers are more likely a reflection of the huge amount of money waiting to be deployed—$278 billion in dry powder as of March 2018[2]—as opposed to investors turning away from the asset class. Indeed, there is sustained optimism about the future, with 81 percent saying the business will be about the same or better in 2018 vs. 2017, according to an informal poll of real estate professionals.[3]

**$110bn (est.) vs. $126bn**

Capital raised in 2017 was substantially less (-13%) than 2016

Source: Preqin

**$278bn (est.)**

Estimated private real estate dry powder as at February, 2018.

Source: Preqin

[1] Source: Preqin – Real Estate Online, January, 2018

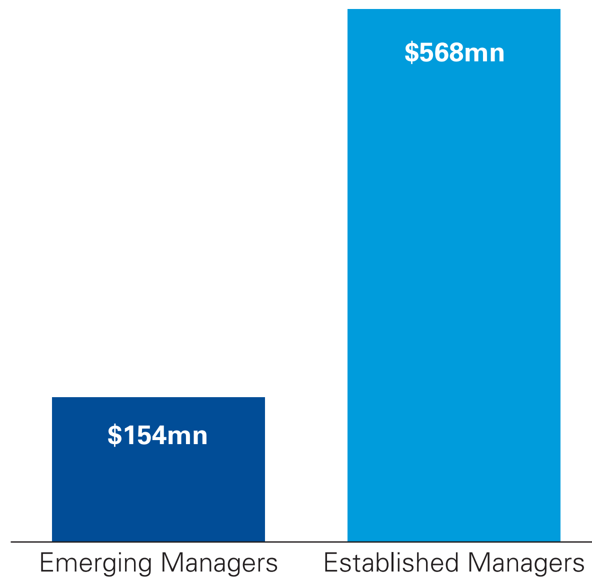
[2] Source: Preqin – Real Estate Online, January, 2018

[3] Source: KPMG and Shelter Rock live audience poll, January 11, 2018 "Real Estate Fund Trends" conference.

# Big funds get bigger

In the past year, the number of new private real estate funds formed declined dramatically. Why? Because large, experienced fund managers are overpowering the market. Established funds are raising larger and larger funds while emerging managers face immense competition to close funds. Today, the average size of an emerging manager's fund is only 27 percent of the average size of an established manager's fund.[4] Better fundraising equals more discretionary investing power, which can create a competitive advantage in deals; this makes it especially clear that size will matter in the future.

**Average size of funds closed in 2017**



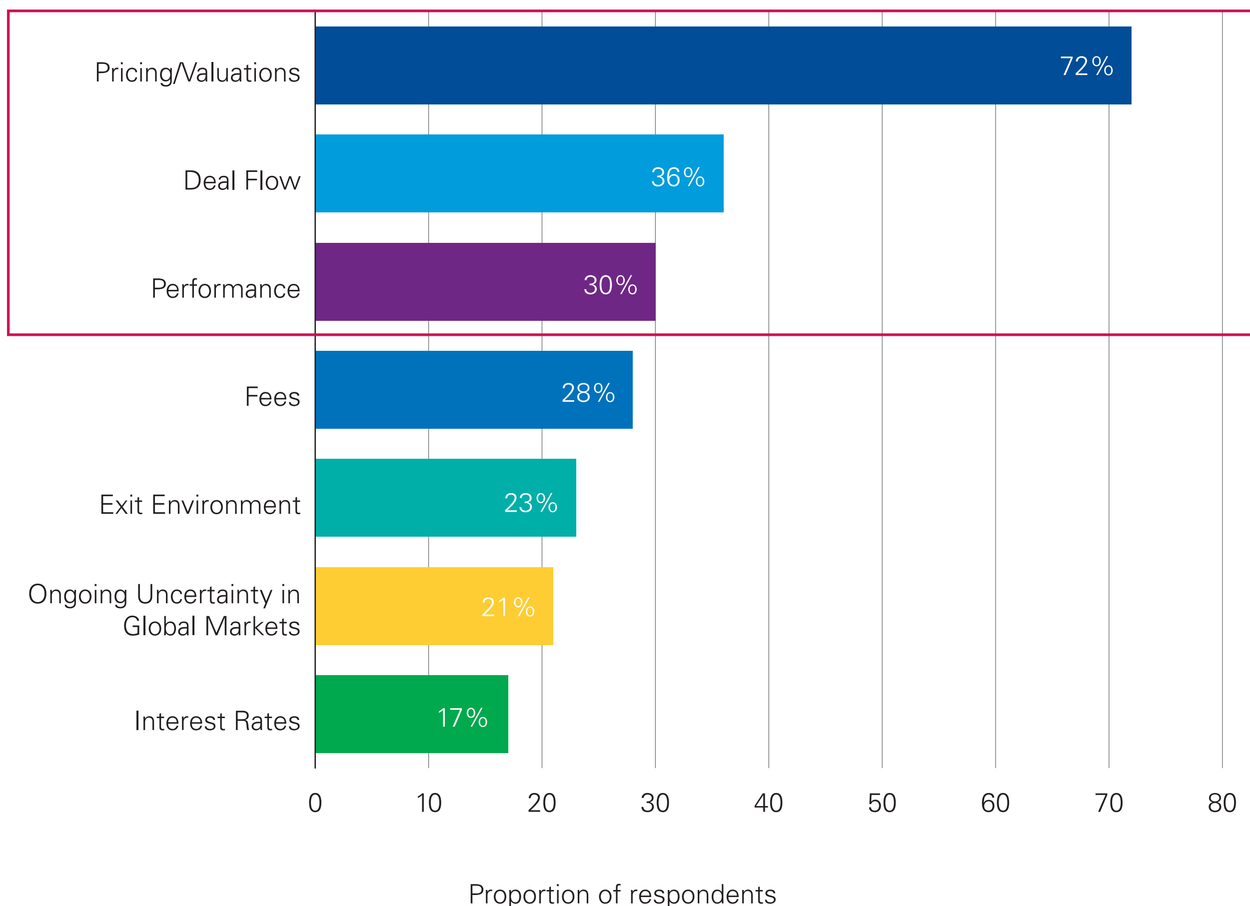

*Source: Preqin – Real Estate Online*

[4] Source: Preqin – Real Estate Online, January 2018

# Good deals are hard to find

Question: What do you get when you combine high property prices, slow deal flow, and historic levels of dry powder? Answer: A robust seller's market. The key issues for real estate investors are real estate pricing, finding deal flow with acceptable risk-return relationships, and future performance. Although real estate capital-raising has slowed, demand remains high with an historic amount of untapped money already available to invest. At the same time, investors are struggling to find opportunistic deal flow in the face of competitive pricing wars in both gateway and secondary markets. As such, we see 2018 as a positive time for property owners with attractive assets to sell at a premium. Respondents are almost equally divided on how the central business district office cap rate for real estate will fare: 36 percent expect rates to go lower, 30 percent expect them to stay the same, and 34 percent expect them to go higher.

**Investor views on the key issues facing real estate in 2017**

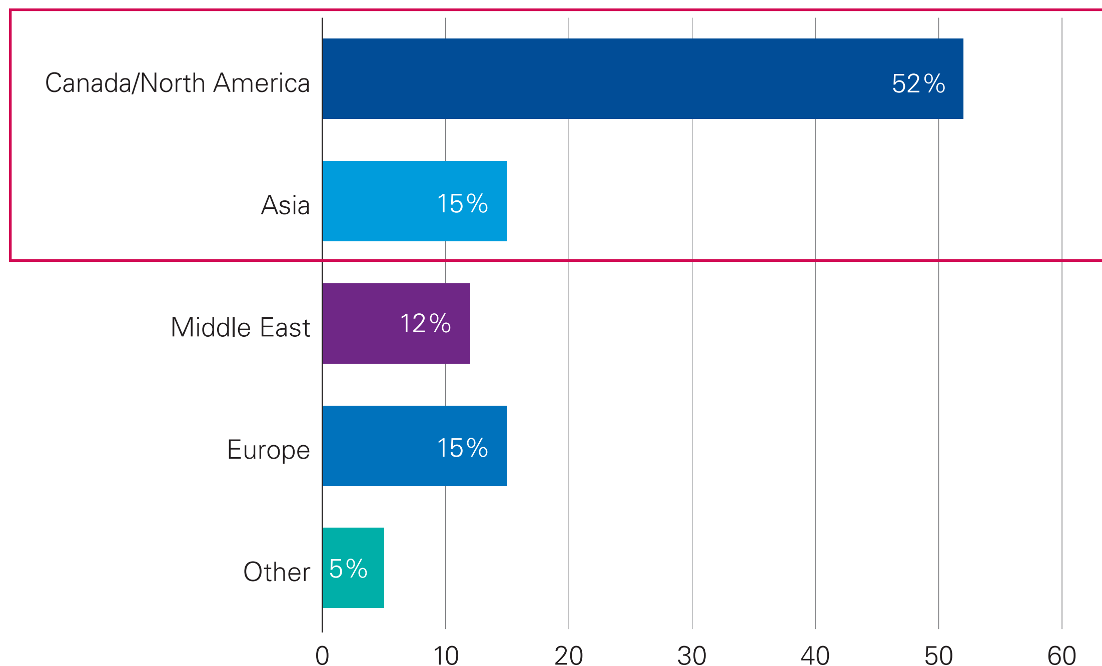



*Source: Preqin – Investor Interviews, June 2017*

# Capital sources continue to be global

Inbound capital continues to play a big role in the U.S. real estate market. In 2017, foreign investment in U.S. real estate came from all over the globe, led by Canada, which invested nearly $20 billion.[5] Respondents overwhelmingly believe (52 percent) that investors from North America will again be the biggest provider of inbound U.S. real estate investment in 2018.[6] Chinese foreign direct investments slowed in 2017 due to the temporary tightening of capital outflows by the Chinese government, but we expect some easing of regulatory restrictions and Chinese investment to slowly return. We see other Asian investors picking up the pace in 2018. For example, rules changes may enable Japanese REITs to expand investment in the United States, which should expand deal competition, especially for core trophy properties in gateway cities where Japanese investors tend to focus.

**What region will have the biggest increase in inbound real estate investment into the United States in 2018?**



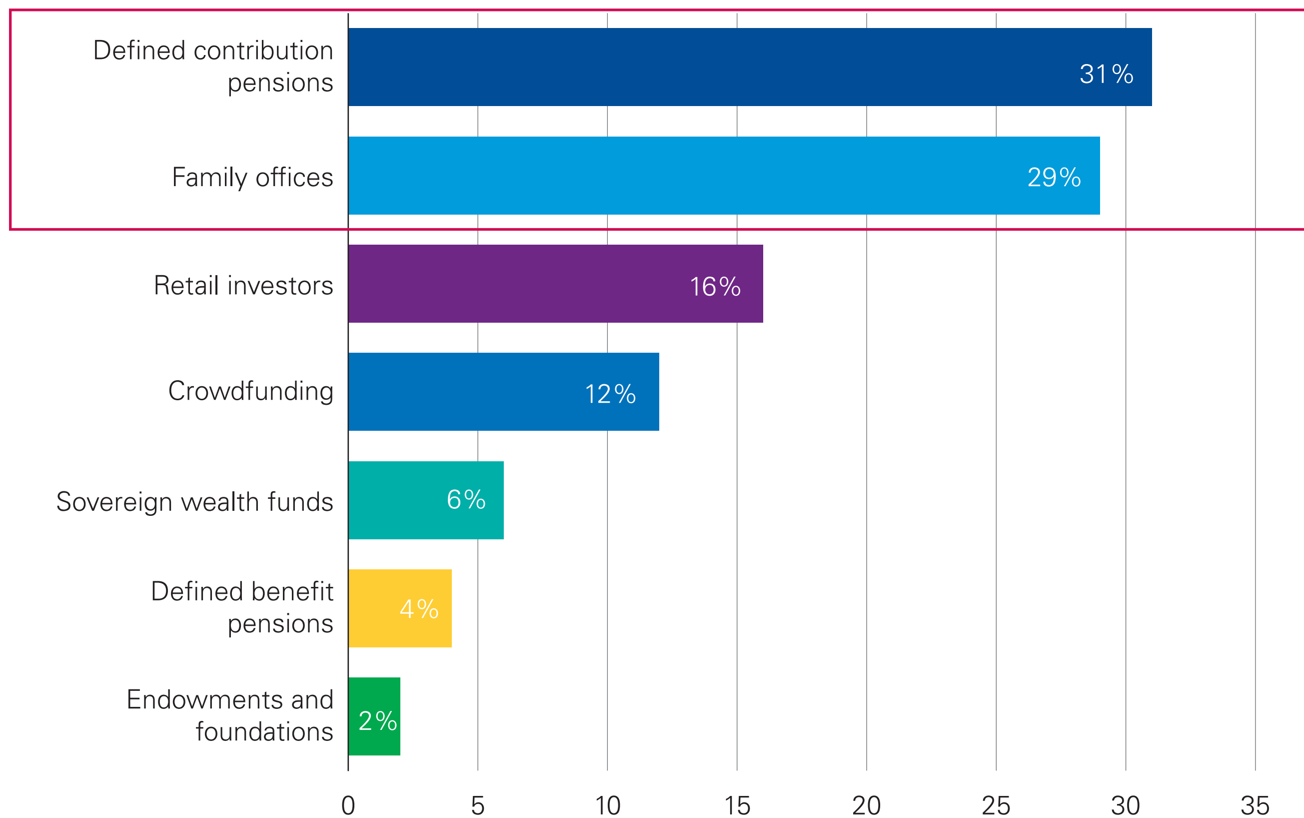

[5] Source: Real Capital Analytics, Inc.

[6] Source: KPMG and Shelter Rock live audience poll, January 11, 2018 "Real Estate Fund Trends" conference

# Private wealth increases real estate investment

While offering good yield and steady returns that are ideal for a fixed-income strategy, buoyant public equity markets have traditionally kept many high net worth investors (HNWs) from investing in what are considered riskier and more illiquid alternative asset classes, including real estate. Recently, however, there is more appetite among HNWs to include real estate funds in their portfolios. For one, individual investors are actively seeking alternatives versus passive investing and public market equity exposure. Additionally, there has been a tremendous amount of product development on behalf of alternative investment firms, some of which predict private wealth channels may contribute as much as 50 percent of their total capital base over time.[7] Many sophisticated wealthy investors seeking to diversify their portfolios are drawn to the favorable risk-reward potential of private real estate as an asset class and the alpha it can produce over the long-term. "If a high net worth investor with a yield-oriented strategy diversifies into private real estate funds and the returns that investor experiences meet or exceed expectations, that investor will be very sticky," said Dan Vene, Co-Founder and Managing Partner, iCapital Network. "Real estate as an asset class, particularly with a distributable yield function, may even take the place of a fixed-income-type investment." Our respondents believe the main sources of capital for private real estate funds in 15 years will be defined contribution pension plans (31 percent), followed by family offices (29 percent).[8]

**What will be the main source of capital for private equity real estate GPs in 15 years' time?**




[7] Source: Blackstone Targets Millionaire Next Door (The Wall Street Journal, October 15, 2017)

[8] Source: KPMG and Shelter Rock live audience poll, January 11, 2018 "Real Estate Fund Trends" conference

# Investors get more active

Passive investing may be a thing of the past. A new generation of active investors—often millennials—are reshaping how properties are bought, managed and sold. These investors tend to roll up their sleeves and get much more involved in the asset management of an investment property. They expect increased transparency, direct alignment, and greater participation and control. In fact, general partners (GPs) are finding that diligence questionnaires have doubled in size, with investors seeking ever-more granular information about everything from water usage and electricity consumption to management fees. "Increasing transparency is critical to a healthy investor partnership. You have to identify where each of your interests lie and clearly explain how you're aligned on strategies and returns," said Josh Carper, Executive Director-Finance, Greystar Real Estate Partners.

Operational due diligence is growing in importance. Investors want to know about operational activities much earlier in the deal cycle than they used to.

—**Walter Stackler,** Managing Partner, Shelter Rock

# Sharpshooting GPs attract investors

"In today's world, where everyone has instant access to virtually the same information, the most important edge in real estate investing is looking at the market more creatively," said Alan Snoddy, Managing Director, The Church Pension Fund (CPF) Investment Group. It's true: The days of winning through an information advantage are over. Now, it's all about finding a unique niche or hidden value. In an increasingly transparent and open real estate market, strong partnerships with key local players who have a deep understanding of end customer needs are more critical than ever to investment success. It's no wonder that, when it comes to deploying money, fund managers increasingly seek to partner with GPs with a narrower focus. "I prefer to partner with owner-operators that don't try to be all things to all people; that are sharpshooters instead of generalists," said Kenneth Munkacy, Senior Managing Director, Kingbird Properties.

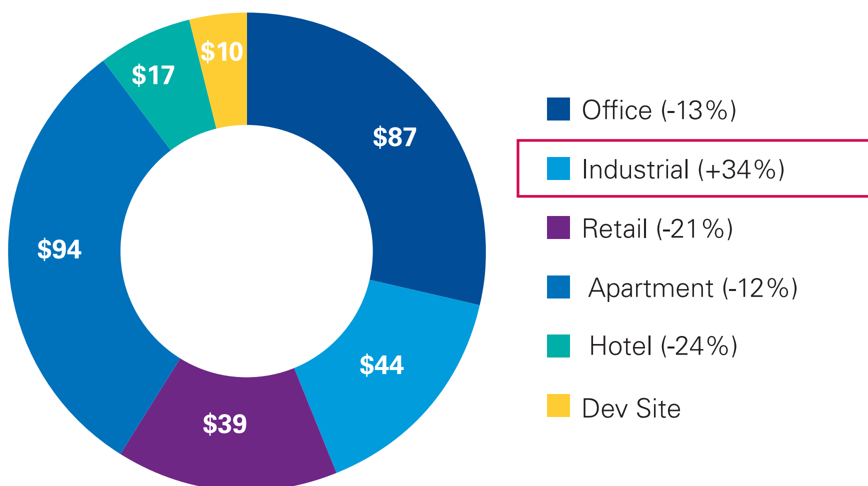
# Retail is alive and changing

As online shopping continues to surge, the national and trade media focus on the challenges facing bricks-and-mortar stores. But retail isn't dead. It is undergoing a secular change that will reduce the available retail space over the next cycle. Despite the fear of widespread disruption to physical stores, 46 percent of real estate insiders boldly predict that good deals still abound in the sector, according to an informal survey of managers and investors.[9] The majority (79 percent) of respondents predict industry changes are coming, including bricks-and-mortar retailers converging with logistics providers, as well as other distribution models.[10]

# Industrial is a darling

As noted above, many real estate investors believe the industrial and retail sectors will morph into a new hybrid sector—properties that support just-in-time delivery to consumers. E-commerce trends have substantially increased the need for well-located logistic centers and last-mile delivery warehouses. In 2017, industrial asset sales—led by logistics facilities—grew by 34 percent over 2016.[11] "There could be a threefold-to-fivefold need for urban warehouses to address the demand created by two-hour delivery strategies promised by certain e-commerce retailers," said Phil Marra, national Audit leader, Building Construction and Real Estate and National Real Estate Funds leader, KPMG.

**U.S. real estate transactions by property type ($U.S. billions)**




[9] Source: KPMG and Shelter Rock live audience poll, January 11, 2018 "Real Estate Fund Trends" conference

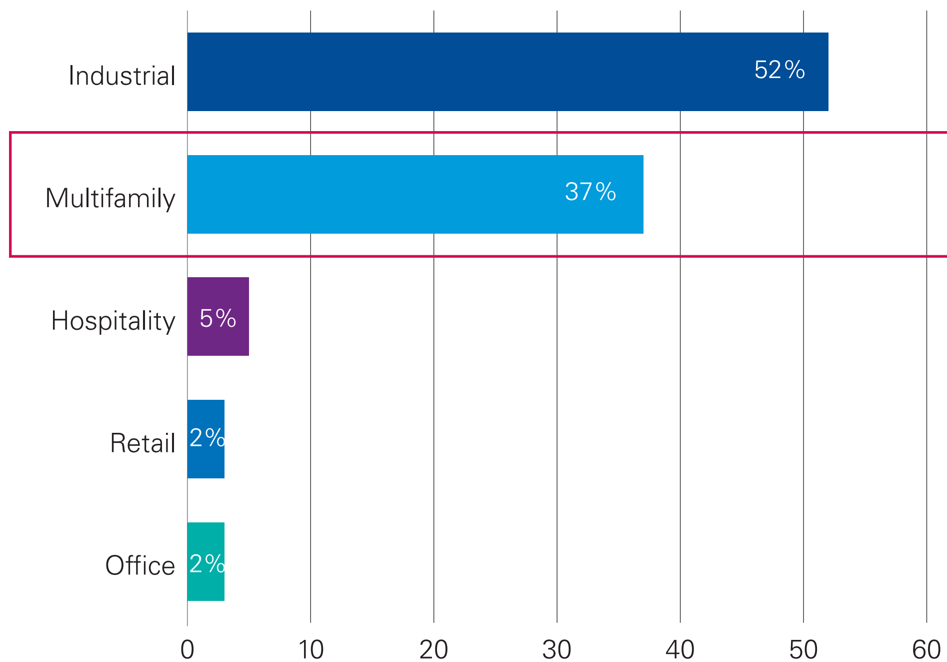
[10] Source: KPMG and Shelter Rock live audience poll, January 11, 2018 "Real Estate Fund Trends" conference

[11] Source: JLL Q3 US Report

# New wind in sails for multifamily sector

The multifamily sector is also poised to grow, according to our poll: 37 percent of respondents think it will be the most popular product type with real estate investors in 2018, second only to industrial (52 percent).[12] In 2017, apartment-style housing accounted for $94 billion in U.S. real estate transactions, the most of all property types.[13] Although concerns among investors over supply-demand imbalances persist, especially in certain gateway markets, the sector is alive and well. "There are lots of factors that will propel the multifamily sector forward, including an overall better economy that will enable 25- to 35-year-olds to move out on their own," said Robert Fraher, New York Real Estate Audit segment leader, KPMG. Factors driving growth include rising interest rates, a strong economy and new tax rules that may discourage home ownership, and increasing demand for affordable apartments across American cities.

**What real estate product type will be the most popular with real estate investors in 2018?**




[12] Source: KPMG and Shelter Rock live audience poll, January 11, 2018 "Real Estate Fund Trends" conference

[13] Source: JLL Q3 US Report

# Debt investing to continue its rise

Real estate debt funds raised nearly $28 billion in 2017, a 26 percent increase from 2016, and their future is looking bright, given their relative risk-adjusted returns compared to equity investment. Ninety-four percent of investors feel their private debt investments over the past three years have met or exceeded their expectations and 62 percent plan to increase their private debt allocation over the long term.[14] Tax law changes may also drive some further increase in the popularity of debt investments.[15] Individuals with investments held through public and private real estate investment trusts (REITs) will be able to take advantage of the new qualified business income deduction that effectively shaves 20 percent off of the tax rate on REIT ordinary dividends. Earning interest income through such a REIT vehicle effectively compresses the rate difference between dividends on corporate equity investments (an effective rate of 20 percent) versus interest income paid as REIT dividends (an effective rate of 29.6 percent as opposed to 37 percent on interest earned directly). These changes could benefit real estate debt investors using mortgage REIT structures.

Preferred equity is a safe place to invest and demand will increase as markets soften.

—**Jason Tighe,** Principal, Square Mile Capital

# Niche investments, new opportunities

Facing high deal costs and competition, investors are targeting niche geographies and property types. In the United States, secondary and tertiary markets continue to bring solid returns at lower prices—although price hikes in cities large and small mean yield isn't as comparatively strong as it once was. Still, high-quality nongateway markets are attracting attention, with innovation hubs in locations such as Denver, Seattle and Austin being especially popular. Many U.S. investors are also expanding across Asia, Europe and Latin America, where they can often find lower deal prices that are available domestically. And nontraditional asset classes continue to gain investor attention, both domestically and overseas, including senior housing, student housing, self-storage and medical office.

[14] Source: Preqin Real Estate Online, January 2018

[15] Source: Preqin Real Estate Online, January 2018

# Tax reform impacts real estate funds

On December 22, 2017, comprehensive tax reform legislation was signed into law. Key benefits specific to the real estate industry include:

— Beneficial treatment of certain qualified business income, including REIT dividends

— The preservation of interest deductions for most real estate investments

— A carried interest provision that generally is manageable; beneficial expensing rules for depreciable properties (although it appears that a technical correction is needed)

— No change to like-kind exchanges of real property

— The retention of key housing tax credits (though the credits' value are impacted by the lower corporate rate); and a 40 percent drop in tax rates for corporations and the Foreign Investment in Real Property Tax Act (FIRPTA).

From a sector-specific perspective, the capped deduction on state and local taxes and more restrictive rules for deductibility of home mortgage interest may discourage home ownership within certain high-cost sections of the country, and in particular for those looking for their first home. In addition, the doubling of the standard deduction further mitigates the tax benefits of home ownership for certain groups. These factors seem likely to increase demand for residential rental units, so multifamily owners, investors and single-family-home rental businesses appear to win under these provisions of tax reform.

When tax reform was being contemplated, the overarching message from real estate leaders was 'do no harm'—don't introduce disruptive changes. And there are actually a lot of interesting things in the tax law that could be very beneficial to the real estate industry.

—**Phil Marra,** National Audit Leader, Building Construction and Real Estate and National Real Estate Funds Leader, KPMG

# Tax reform will have positive secondary effects

Among our poll respondents, 88 percent believe tax reform will have a positive impact on the industry.[16] We agree. Both investors and managers are poised to benefit from secondary impacts of economic growth and capital influx that are expected to come from individual and corporate income tax cuts and changes to rules governing trillions of dollars currently held overseas. We see a significant potential for new or modified sources of capital. The forced repatriation of offshore earnings means that an estimated $2.6 trillion of offshore earnings can now be brought home and invested in U.S. assets—including U.S. real estate—rather than sit offshore in relatively liquid, low-yielding foreign assets. It is expected that U.S. companies will accelerate an estimated $50 billion in contributions to underfunded corporate defined pension plans due to the drop in the corporate tax rate,[17] bringing with it an estimated $5 billion of unexpected capital that will be committed to institutional real estate by September 2018, assuming typical real estate allocations. Although home ownership (and therefore the single-family property industry) may be negatively affected by tax law changes, overall lower tax rates should grow jobs, GDP and capital—and therefore property investment.

So much of the conversation in real estate circles focuses on the domestic benefits of the new U.S. tax rules, but we also see significant opportunities for foreign investors with the reduction of the FIRPTA rate.

—**Dene Dobensky,** Tax Partner, Building, Construction and Real Estate, KPMG

# But the tax law is more complicated than the headlines

Despite the sunny outlook, we expect real estate investors, fund managers and owners will face major challenges executing the new tax rules. The law contains significant and complex limitations on who qualifies for deductions. Determining what elections to make and deductions to claim will be the result of intensive analysis and modeling. Once the analysis of the impact of the rules is complete, and a business understands what provisions and exclusions apply, a realignment or restructuring may be necessary to maximize its benefits. Given these complexities and uncertainties, we expect applying new tax rules will be a major challenge for the industry for months or even years.

[16] Source: KPMG and Shelter Rock live audience poll, January 11, 2018 "Real Estate Fund Trends" conference

[17] Source: Tax Reform to Fuel Increased Corporate Pension Contributions – GSAM (The Wall Street Journal, Jan. 9, 2018)

Tax reform is obviously more complicated than the headlines. It's going to be a significant challenge for real estate funds to deal with all of the different scenarios.

—**Jim Sowell,** Principal, Washington National Tax, KPMG

**Change is gusting in the U.S. commercial real estate market. We have highlighted the critical headwinds and tailwinds that we believe will impact investors and fund managers in 2018. Whether they succeed will depend on how effectively they understand, anticipate and execute against the disruptive forces at play.**

# About KPMG's Real Estate practice

KPMG advises owners, managers, developers, lenders, intermediaries, construction and engineering firms, and institutional investors in effectively executing complex transactions ranging from acquisitions and dispositions to securitization of real estate properties and portfolios to entity-level mergers and acquisitions. We believe that our experience and knowledge can help you successfully address today's challenges while preparing for tomorrow's opportunities.

To learn more about KPMG and our insights, visit us at kpmg.com.

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Phil is the national Audit leader for the Building, Construction & Real Estate practice and national Real Estate Funds leader at KPMG. He has more than 30 years of experience in the asset management sector, providing audit, accounting, due diligence, and advisory services to real estate, finance, parking, construction, and hospitality companies. He provides insight to a wide range of organization types, including public companies, owners, developers, managers and tenants of office, retail and residential properties, real estate opportunity funds, REITs, private equities, government agencies, not-for-profit enterprises, lenders, syndicators, foreign investors, real estate advisers, asset managers, and construction companies. He is also a member of the U.S. Real Estate Leadership team and the New York Financial Services Leadership team at KPMG.

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Dene is a partner in KPMG's New York Real Estate Tax practice. He has over 30 years of experience in the real estate funds industry, having recently rejoined KPMG after 12 years as the tax director of UBS Realty Investors, fund manager for over $30 billion of REIT-based equity and debt funds and separate accounts. He brings to real estate asset management industry experience in the formation and management of funds, with a focus on inbound institutional capital. His prior experience included serving as executive vice president of tax for alternative investments for a major life insurer/international bank. He is a member of the American Institute of Certified Public Accountants. He is a licensed Certified Public Accountant in Connecticut, pending in New York.

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Robert is the New York Real Estate Audit segment leader at KPMG. An Audit partner in the Asset Management practice, he has more than 25 years of accounting and auditing experience including investment funds, private equity, construction, and commercial and residential properties. He has a wide breadth of experience across alternative investments. For nine years in KPMG's international rotation program, he worked in Russia, Eastern Europe, and the Middle East across various industries, including alternative investments such as cross-border joint ventures and investment funds.

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Jim is a principal in the Passthroughs group of the Washington National Tax practice of KPMG, focusing primarily on tax issues relating to partnerships and REITs and debt workouts for such entities. He currently leads the Real Estate practice for Washington National Tax. He was previously with the U.S. Department of the Treasury (Office of Tax Policy), where he served first as an attorney adviser and then as an associate tax legislative counsel. He is a former chairman of the Real Estate Committee of the American Bar Association (Tax Section) and is a former vice chairman of the Tax Policy Advisory Committee of the Real Estate Roundtable.

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