Real Estate Co-Investments

THE CO-INVESTMENT EVOLUTION

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CLUB ESTATE

KEY POINTS

>> Implemented initially to sporadically fill a financing gap co-in vestment solutions have over the last years revolutionized the way family offices and institutional clients allocate their capital into real estate.

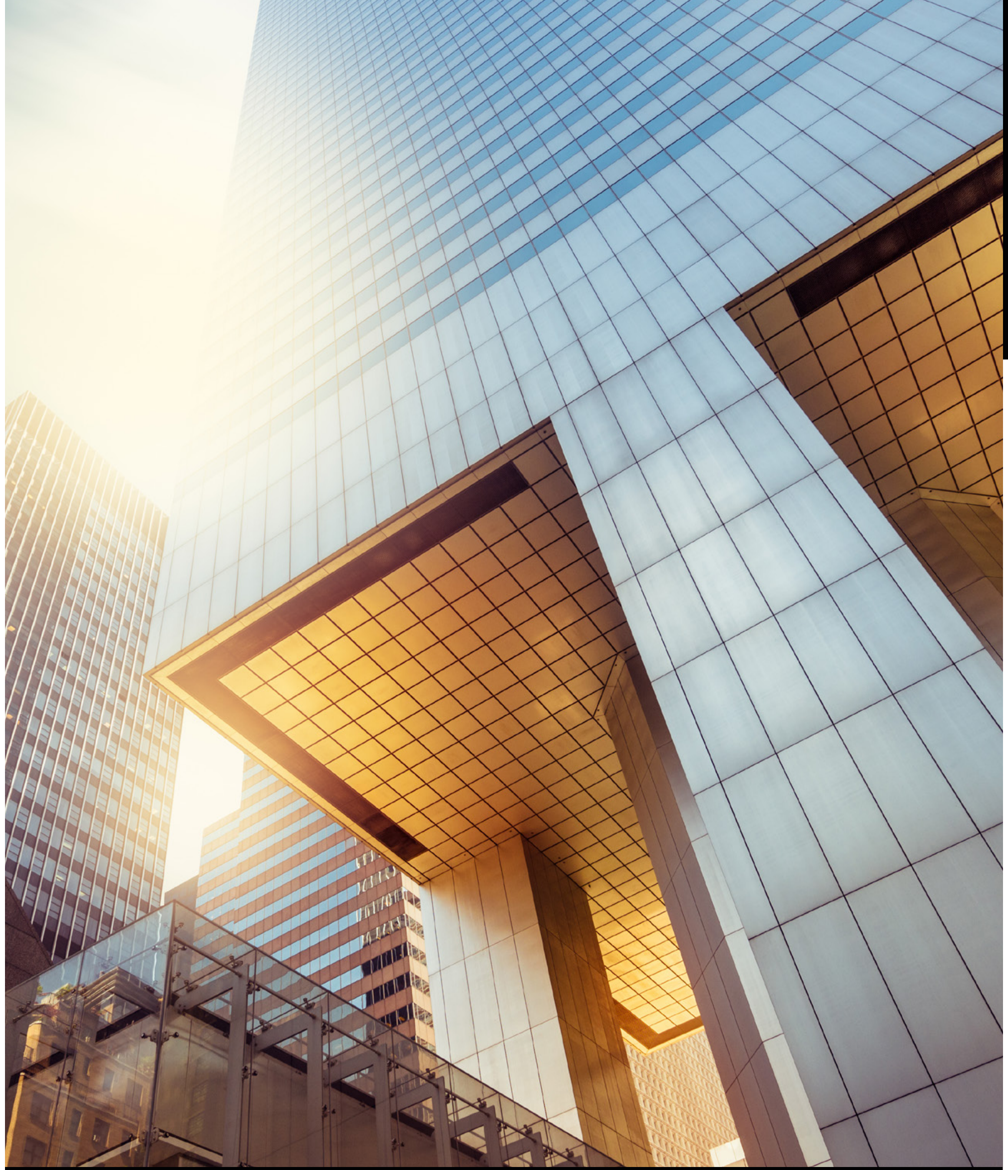
>> Partial-ownership transactions have represented between 6.3% and 9.5% of total real estate transactions with an average volume of roughly $36bn.

>> Co-Investment returns tend to outperform fund returns as studies from private equity markets illustrate.

>> There is no common definition of the various co-investment solution terms. While some investors reduce defining criteria to only the number of participating investors, others include characteristics, such as alignment of interest via equity participation, control rights, holding structure, operating mechanisms, investment policy or the regulatory framework to define the respective co-investment solution.

>> Co-Investments are generally either titled as joint ventures, club deals or sidecar investments in funds.

>> Investors regard access to attractive deals, alignment of interest and the efficient deployment of capital as some of many advantages of co-investment solutions.



INCREASING DEMAND FOR CO-INVESTMENT SOLUTIONS

Private real estate assets under management (AuM) continue to grow and have reached approximately $909 billion in 2018[1]. The increased relevance of co-investment solutions has been driven by institutional investor demand for co-investment arrangements and the fact that the high interest in private real estate markets has intensified competition to raise capital for real estate funds and has led investment managers to become more flexible in regard to capital raising. As a result, co-investment solutions (joint ventures, club deals and funds with sidecars) have become a key offering in the private market industry. *Figure 1* illustrates the volume of partial-ownership transactions in real estate. Over the last six years, an average of roughly $36bn exchanged hands in partial-ownership real estate transactions per annum, representing between 6.3% and 9.5% of the entire real estate transaction market. A survey by PERE[2] highlights the fact that the top 20 private real estate investment managers have increased their five-year co-invest volume by $10bn from 2016 to 2018.

This represents an increase of roughly 33% and underlines the strong demand for co-investment solutions even among the top investment managers in order to tap into new capital. Co-investment solutions are not only popular with the top investment managers, but also smaller players make use of the instrument in order to close transactions that require additional capital.

After a downturn, partial-ownership transactions rose in 2018

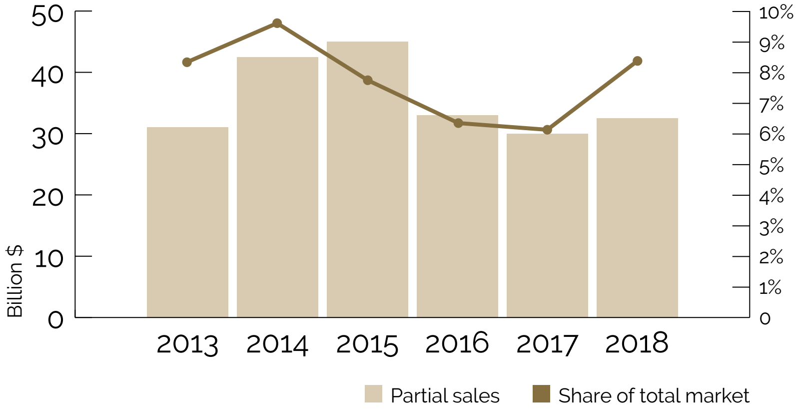


Figure 1 *– Partial-ownership in real estate , *Through Q3 2018 Source: PERE*

[1] *Preqin 2018*

[2] *PERE, 2019, Campell, Kyle, The art of co-investing in private real estate*

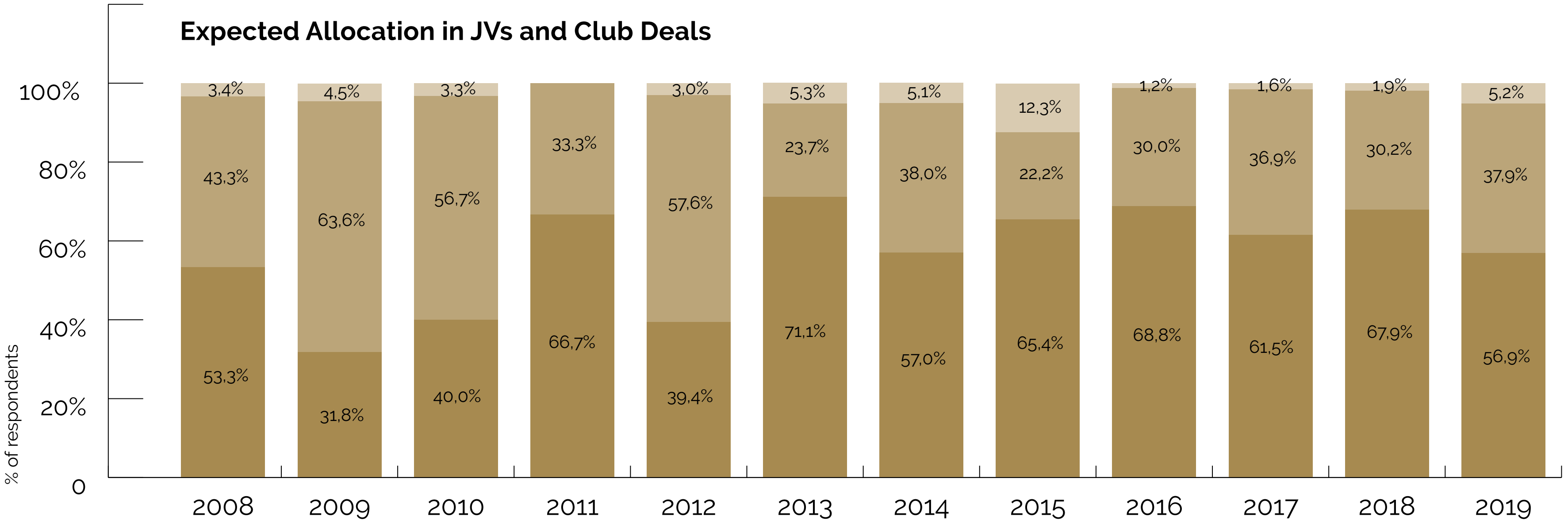


Figure 2 *– Expected Allocation in JVs and Club Deals, Source: INREV 2019*

A recent study by INREV (2019) indicates that the demand for co-investment solutions such as joint ventures and club deals will continue to remain high or will even increase in the near future as illustrated in *Figure 2*.

Compared to real estate funds with a well-diversified portfolio, co-investment solutions can be beneficial and deliver more attractive return to investors. While there is little research on co-investment returns in the real estate industry, co-investment's potential to outperform fund returns has been demonstrated in the private equity industry. A survey conducted by Preqin[3] came to the conclusion that returns of past co-investments have mostly exceeded returns of private equity funds by more than 5%.

[3] *Preqin 2015*

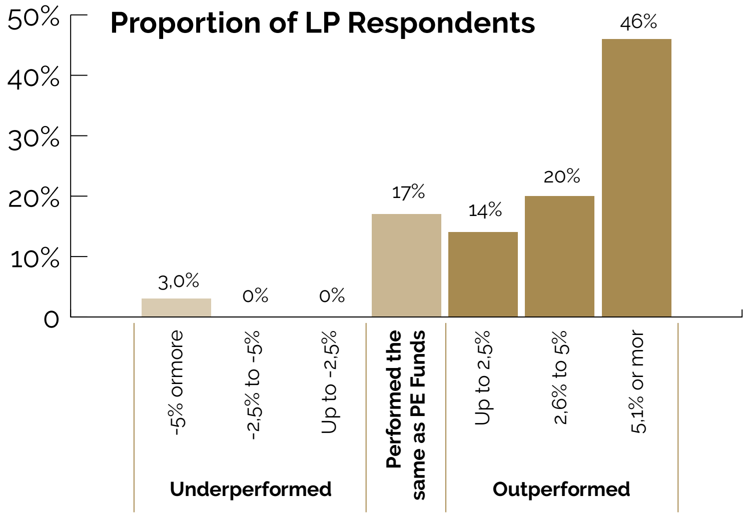
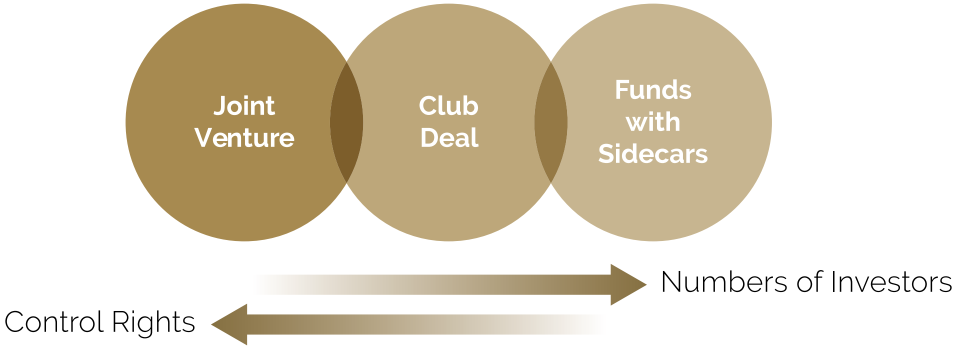


Figure 3 *– Co-Investment Performance vs Fund Performance Source: Preqin*

CONFUSION AROUND CO-INVESTMENT SOLUTIONS

Despite the increasing demand for real estate co-investments, there is little to no consensus in the private real estate market on the definition of what constitutes the various co-investment solutions. While some players identify only the number of investors as distinguishing characteristic, others also mention numerous other parameters (i.e. equity share) in a recent INREV survey[4], as important in order to differentiate among the various co-investment opportunities.



[4] *INREV, 2019, Coming of age - the rebirth and renewal of the non-listed real estate industry*

CHARACTERISTICS	JOINT VENTURE	CLUB DEAL	FUND WITH SIDECARS
NUMBER OF INVESTORS	2	Min. 3 (avg. 3-6)	many
EQUITY SHARE	Equal shares (sometimes dominant partner)	Equal shares (sometimes dominant partner)	minority stake in fund & major stake in single asset
CONTROL RIGHTS	High	Medium	Low
HOLDING STRUCTURE	GP/LP	Closed-end	Closed-end/ open-end
OPERATING / MANAGING PARTNER	One of the JV-parties	Either one of investors or third party	Third-party
INVESTMENT POLICY	Single asset/narrow focus	Narrow opportunity focus	Broader scope
REGULATION	Non-regulated	Non-regulated	Regulated

Broadly speaking, there are three different co-investment solutions in the private real estate market, namely joint ventures, club deals and funds with sidecars.

76% of real estate funds in the market offer co-investments to their fund investors. In such arrangements, either all investors have the same right to opt into a pro-rata share of the co-investment based on the initial fund investment (large investors take priority) or co-investing rights are set individually during the fundraising phase. In terms of number of investors, private real estate funds may only have as little as 5 investors when structured as closed-end product, but generally have way more (>10) especially when structured as an open-end product. Furthermore, the vehicles are regulated (i.e. AIFMD), managed by a third-party investment manager and follow a broader investment policy. Individual control rights for investors are rather low as most decisions are at the discretion of the fund's appointed investment manager.

Club Deals are characterized bringing together min. 3 investors, which follow the same narrow opportunity focus with one or a few investments. Equity can but does not have to be equally distributed among investors. The non-regulated closed-end structure allows maximum flexibility for investors. A third-party manager is most commonly appointed to execute the business plan. Only in a few cases, one of the club investors is simultaneously the investment manager and therefore has skin in the game, too.

Joint Ventures are setup as flexible, non-regulated structures, mostly as GP/LP structure. Equity shares can but do not need to be equally distributed between the two investors. One of the investors is appointed to manage the property. There is no third-party investment manager involved.

BENEFITS OF CO-INVESTMENT SOLUTIONS

Deal-by-deal real estate co-investments have become a powerful instrument for professional investors. Even though implementation varies as discussed in the prior chapter, participant's rationales to co-invest are very much alike. Investors expect access to attractive deals through co-investment solutions and the ability to construct a portfolio aligned with their investment targets. By working together with handpicked partners, so called local champions, investors can mitigate managing and operational risks.

[5] *Preqin, 2017, Preqin Special Report: Real Estate Co-Investments and Separate Accounts*

Local champions demonstrate profound track records in the region and sector and therefore allow for knowledge transfer among partners. Furthermore, favorable terms and aligned interest lead to outperforming returns compared to other business models. Finally, co-investments represent an effective way to deploy capital for the investor and increase the AuM of the managing partner significantly.

MITIGATE RISKS

There are risks associated with real estate investments and some specifically to co-investing. As a people's business, investors new to private market real estate investing may find it difficult to build up the necessary relationships and even harder to identify and access co-investment opportunities in the market. It takes time to build-up a network with trustworthy counterparties to invest alongside.
As soon as co-investment opportunities are sourced, investors often realize the time-sensitive nature of such deals and struggle with the required speed of execution. Simultaneously, investors struggle with the regulatory and compliance hurdles that also adversely affect their speed and thus often lead to failure.
In order to overcome those pitfalls and mitigate risks, investors that plan to invest in real estate co-investments should either built-up resources internally or partner with specialized boutiques.
A systematic selection process on manager and deal level is key to guarantee trustworthy best-in-class partners with the respective expertise and knowledge in terms of region, sector and style. Track record of executed deals, the senior management team, incentive or governance structures should be assessed rigorously.

Investors should also review co-investment opportunities closely in regard to the compatibility to their investment strategy with a focus on control rights, business model, fee levels and time horizon. They should also check whether the investment manager's capability match the expertise needed to execute the business plan. And last but not least, transparency among partners is key to successfully co-invest and therefore fees should be fully outlined.

CONCLUSION

Co-investment solutions have become an integral part of the private real estate market. The boundaries among the various solutions are still blurred but will become clearer as more investors will participate and co-investment offers in the real estate market industry will mature. However, co-investments should not be approached lightly and challenges that come with them should be considered in order to fully benefit from advantages of such investments. Specialized external advisors add value for investors which do not have the access and internal resources for a manager and deal level due diligence.

ABOUT
CLUB ESTATE

Club Estate was established in 2018 in Switzerland as a dedicated real estate co-investment boutique for ultra-high-net-worth individuals, family offices, pension funds, sovereign wealth funds and endowments. The Club Estate business model is based on three principles. Providing selected Family Offices and institutional clients exclusive access to best in class real estate co-investments. We partner with local "champions" going through a systematic proprietary manager and deal selection process. We also focus on alignment of interests between the investor and the investment manager. Thirdly we offer assurance for the investor. Fee transparency as well as the manager and deal monitoring is part of our value proposition. All of this is powered by a state of the art digital platform.

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