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Berkshire Capital Securities LLC

535 Madison Avenue, 19th Floor
New York, NY 10022
+1 212 207 1000

One Market Street, Spear Tower, Suite 3600
San Francisco, CA 94105
+1 415 293 8426

999 Eighteenth Street, Suite 3000
Denver, CO 80202
+1 303 893 2899

Level 2, 9 Castlereagh Street
Sydney, NSW, 2000
+61 419 460 509

Berkshire Capital Securities Ltd

Cayzer House
30 Buckingham Gate
London, SW1E 6NN
+44 20 7828 2828

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Commercial real estate rebounds, benefiting real estate investment managers

As the financial crisis played out between November 2007 and January 2010, the Moody's and Real Capital Analytics (RCA) U.S. Commercial Property Price Indices took a sharp downward turn, dropping 40%. In 2009, transaction volume of $54 billion was just 10% of the value recorded two years earlier. "From 2008 through 2009, the commercial real estate market was at a virtual standstill," the Wharton School's Zell/Lurie Real Estate Center wrote at the time, adding: "With few investors willing to step up because of questions regarding the accurate pricing of risk, real estate values plummeted."

Five years after that assessment, the U.S. commercial property market has done an about-face: By October of this year, the Moody's and RCA Indices had climbed 14.5% above the November 2007 peak on a nominal basis and 1.5% on an inflation-adjusted basis. As the data suggest, demand for commercial property investments has rebounded sharply, and not only in the U.S. Investors are also pumping money into property in Europe and Asia-Pacific, although investment in Asia-Pacific has tailed off this year. In the U.S., real estate deals climbed 36% to $225 billion in the first half of 2015 compared with the year-earlier period and 37% in Europe to €135 billion ($150 billion).

Accordingly, fundraising has been strong. **Blackstone Group** recently closed the largest-ever private equity real estate fund, at $15.8 billion. Somewhat riskier opportunistic funds such as Blackstone Real Estate Partners VIII dominated closings in the third quarter of 2015, accounting for three-quarters of the $38 billion in closed-end private equity real estate funds raised globally, according to researcher Preqin. For the first three quarters, opportunistic private equity real estate funds raised $48 billion globally, or 38% more than in 2014 as a whole. "With more mega funds currently being marketed," Preqin wrote, "and institutional investor appetite for opportunistic funds still high, fundraising is likely to remain strong in the coming quarters."

The slow but steady economic recovery in the U.S. and elsewhere accounts for part of the bounce. In particular, demand for commercial space in first-tier cities has been strong, with prices reaching new highs in Berlin, Hong Kong, London, Los Angeles and New York, among others, according to RCA. Additionally — and ironically considering that the meltdown began in an overheated real estate market — commercial property has also gained an assist from the post-crisis stimulative policies pursued by central banks worldwide. As investors review the paltry interest paid on sovereign debt and investment grade bonds, commercial real estate has beckoned.

Indeed, even as prime yields in the 14 European real estate markets covered by **BNP Paribas** dropped a collective 50 basis points in the first nine months of this year, the French bank still emphasized the "very attractive" gap with government bonds. In a similar vein, Phil McAndrews, **TIAA-CREF**'s senior managing director and chief

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investment officer for global real estate, told *Pensions & Investments* in October: "As we stand right now in the United States and globally, we feel very strong demand in the asset class, primarily because the delta between the return rates in real estate and the risk-free rates in U.S. Treasuries remains strong."

Institutional investors have been the driving force in the comeback of commercial real estate, prodded along by those minuscule interest rates, as well as a post-crisis appreciation for property as a relatively stable long-term investment. The ability of investors to achieve largely uncorrelated returns is another plus, as is the transparent and straightforward nature of the investments. According to the latest survey by Hodes Weill & Associates and Cornell University's Baker Program in Real Estate, institutions worldwide responsible for $8 trillion in assets planned to hike their real estate target allocation in 2015 to 9.6%, or 24 basis points higher than in 2014 and 49 basis points higher than in 2013. Cross border investment has also been increasing while third-party management is gaining at the expense of in-house management: 70% of institutions covered in the Hodes/Cornell survey report that all their real estate investments are handled by third parties and all institutions say they are three times more likely to allocate fresh capital to third parties than in-house management.

One of the world's largest sovereign wealth funds, the $860 billion **Government Pension Fund of Norway** oil fund, said in 2013 it would bump its real estate target from 1% to 5%. The largest public pension fund in the U.S., **California Public Employees' Retirement System**, is taking a similar tact. In 2014, as CalPERS announced the unwinding of its hedge fund portfolio, the $290 billion fund said it will increase its real estate target from 8.6% to 10%, with recent investments tilting toward separately managed accounts and a focus on high-quality assets. In Japan, the $1.2 trillion **Government Pension Investment Fund** has also raised its real estate, infrastructure and private equity allocation to 5% as it begins to break free of its traditionally conservative investment posture to boost returns.

The robust activity has naturally benefitted real estate advisors. Among the 93 largest real estate investment managers in *Pension & Investments* latest annual survey, which includes REITs, growth in worldwide assets reached pre-crisis levels of 20% in the 12 months through June 2015, with assets touching $1.2 trillion. The demand for such investments is also reflected in an active M&A market for real estate advisors: In 2013-2014, 26 such deals valued at $2.3 billion were announced, with 2015 proving similarly busy.

Many of the transactions have crossed borders, underlining the global nature of much of the industry's deal-making, in sync with investor demand for such exposure. For example, non-European investors have accounted for 59% of total real estate investment this year in the European markets covered by BNP Paribas. Other deals, such as **Sun Life Financial**'s acquisition of **Bentall Kennedy Group** in June, are representative of how financial services firms and diversified asset managers are expanding existing real estate capabilities.

Sun Life-Bentall Kennedy is one of the largest such transactions in recent years, with the Toronto-based insurer paying C$560 million ($455 million), or approximately 10 times estimated 2015 EBITDA (earnings before interest, taxes, depreciation and amortization). One of North America's largest advisory firms and also based in Toronto, Bentall Kennedy adds C$28 billion in real estate AUM and 550 clients to the C$20 billion in commercial mortgage and real estate assets managed by Sun Life, with assets for both firms concentrated in North America. The acquisition coincides with Sun Life's effort to move into third-party asset management, in addition to expanding its real estate platform. Chief Investment Officer Stephen Peacher told Canada's Business News Network that the goal of the transaction "was to take some of the alternative yield strategies like real estate and commercial mortgages that we've used at Sun Life and bring them to investors. Bentall Kennedy ... [is] a natural extension of that real estate expertise." Bentall Kennedy is itself a creation of the 2010 merger of what was then Kennedy Associates of the U.S. and Canada's Bentall.

TIAA-CREF, one of the world's largest real estate advisors and asset managers, engaged in two transactions this year with Europeans. One involved forming a joint venture with **Swedish National Pension Funds AP1** and **AP2** with the goal of "create a leading pan-European office investment platform." The initial platform will consist of properties from TIAA-CREF's general account and AP1 and AP2 valued at €2.2 billion ($2.5 billion), with the New York firm acting as manager. The joint venture plans to make an additional €2 billion investment over the next three years targeting core investments in leading cities such as Frankfurt, London and Paris. AP1 and AP2 are among five separate investment funds in Sweden's pension system.

In the second deal, TIAA-CREF bought out the 40% interest of **Henderson Global Investors** in the advisory joint venture the two established in 2013, when TIAA-CREF acquired the London-based firm's U.S. real estate advisory business. TIAA-CREF paid £80 million ($123 million) for Henderson's share of **TIAA Henderson Real Estate**. THRE has $26 billion in AUM in Europe, North America and Asia invests in core and value-add commercial real estate. Since being established, THRE has gained $1.3 billion in new mandates and secured $3.6 billion in capital recommitments from closed-end fund investors.

Other cross border deals this year include the €145 million ($155 million) acquisition by Australia's **Cromwell Property Group** of pan-European property funds manager **Valad Europe**, which has some €5 billion in AUM. The deal more than doubles Cromwell's total funds under management and complements the Brisbane firm's Asia-Pacific focus. London-based **Savills Investment Management** (formerly known as Cordea Savills) was involved in two cross border transactions, acquiring Frankfurt's **SEB Asset Management** to create a firm with €15 billion in AUM in a variety of European-focused fund structures and another €2 billion in an Asian platform. SIM said the deal adds "to our critical mass and enhance(s)

our ability to offer investment opportunities to clients.... and strengthen(s) our position as one of the leading investment management propositions in Europe and Asia." SIM also created a joint venture with privately held **China Minsheng Investment Capital** of Shanghai to develop and market a series of global real estate funds and investment vehicles. In the first such investment, China Minsheng provided up to €30 million in seed capital for the CMISIM European Investment fund.

Domestic U.S. transactions have been quiet this year, but one small deal of note involved an ambitious Richmond, Va., advisory firm, **Allegiancy**, which acquired **TriStone Realty Management**. Allegiancy has set an aggressive five-year goal of managing $10 billion to $15 billion in real estate AUM, with TriStone doubling Allegiancy's AUM to $1 billion. Houston-based TriStone also expands Allegiancy's geographic footprint, adding 3 million square feet of property in nine states.

Founded in 2005, Allegiancy specializes in office properties and touts its ability to combine proprietary technology that provides real-time data for each property with an "intense focus on cash flow and profitability" to bring "fresh vigor to an often poorly understood business." The company raised $5 million in capital in 2014 and filed this year with the SEC to raise another $50 million. The company has been a vocal proponent of the 2012 federal JOBS Act, which allows small companies to raise up to $50 million in private funding without tripping certain costly reporting requirements. Allegiancy CEO Steve Sadler told Richmond (Va.) BizSense that the capital is designed to assist his firm in buying "quality operators and bring[ing] them in as affiliates." With rumors of numerous other pending transactions and continued solid returns in the sector, the outlook for continued activity in the sector promises to be intense. ▲

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