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Secondaries & Recapitalizations

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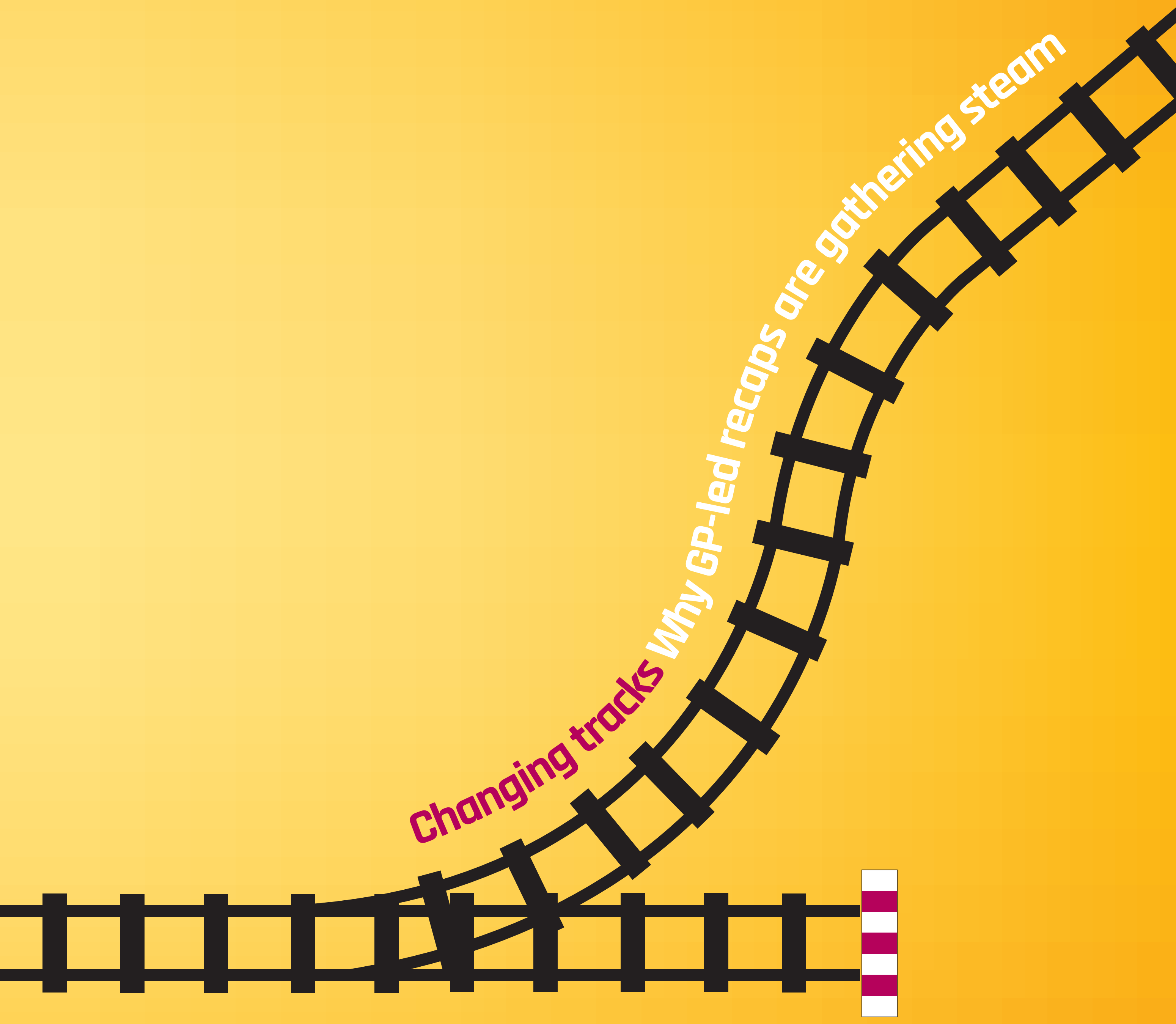

KEYNOTE INTERVIEW

Manager recaps: A passport to in-demand sectors

GP-led transactions can provide buyers with access to unique dealflow in high-growth segments, says Brookfield's head of real estate secondaries, Chris Reilly

Over the past 18 months, global asset manager Brookfield has committed $1.8 billion of equity within the real estate secondaries space, almost exclusively in manager-led recapitalizations. Chris Reilly, managing partner and head of real estate secondaries in the firm's Real Estate Group, tells *PERE* how Brookfield has used the secondaries market to deploy quickly at scale in hot property sectors such as logistics, and discusses the opportunities and challenges facing investors in the GP-led space.

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Q Why has Brookfield chosen to focus on GP-led secondaries?

GP-led deals are probably more than 90 percent of what we do within real estate secondaries. What sparked our interest is that GP-led transactions are very much like direct real estate investing. We have a large real estate business at Brookfield, and this is a part of the market where we have an informational and operational advantage through our boots on the ground within our various operating platforms across property sectors globally.

Over the past several years, we have followed the evolution of secondaries from fund of funds and LP investing, where the amount of information available to secondaries investors is limited, to GP-led deals, where it is far more granular. Taking a more bottom-up approach through manager-led deals enables us to use our real estate underwriting skills.

GP-led recapitalizations offer a different entry point than a direct real estate approach, provide investors with unique access to dealflow, and enable them to invest thematically. These transactions also help to mitigate the J-curve, providing investors with a balance of both income and appreciation, which is important in the current inflationary environment.

Q How can investors utilize manager-led secondaries

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to access in-demand property sectors?

That thematic angle is one of the reasons why our investors like the kind of dealflow we see in GP-led secondaries. A lot of opportunities arise in segments with favorable characteristics, such as logistics, residential, and some of the alternative sectors like life sciences and self-storage. GPs see there is still a lot of growth potential left if they hold on to the assets for a few years beyond the typical one or two years by which they can extend an existing fund.

Logistics is a good example. In most industrial markets, we see significant rent growth, increasing replacement costs and limited supply. If a manager has spent five to seven years buying assets and constructing a portfolio, that portfolio is probably rented under market at this point in time. There may be additional value-add opportunities, for which the manager needs another five years to execute on their plan.

That motivates a GP to want to retain the assets so they can continue to capture that upside. If they were to sell instead, and then go out and rebuild that portfolio, it would take a lot of time and capital. Pricing is now significantly higher, even if you can get access to the product. That creates a nice dynamic for a recapitalization deal. The manager knows the portfolio, having already worked it for several years and gotten all the kinks out. Now they can provide a monetization that their existing LPs will be happy with, and buyers like us can come in to help the GP to achieve the remaining upside in the portfolio.

There is a similar dynamic at play in the residential sector. In the current environment, where investors are looking to put more capital to work in the residential and logistics sectors, buying

Capturing rental upside in US industrial

Transaction case study: Longpoint Partners logistics portfolio

At the end of March, Brookfield's secondaries business closed a $700 million recapitalization of a logistics portfolio held in one of Boston-based manager Longpoint Partners' closed-end funds. Longpoint will retain an interest in the portfolio, and will continue to manage its operations. The collection comprises 31 high-quality logistics properties in infill locations, including New Jersey, DC, Dallas, South Florida and Boston. The assets are approximately 97 percent leased to over 200 tenants.

"This complex GP-led recapitalization allows Longpoint to stay involved with the assets and continue to drive value across the portfolio over the next five to seven years," says Brookfield's Reilly. "An additional attraction to working with us is that we can be a one-stop capital source for groups like them. We often provide growth capital in addition to the recapitalization."

The transaction demonstrates Brookfield's strategy of using the secondaries market to secure hard-to-acquire industrial assets. Within the past year, the firm has carried out similar recapitalizations of logistics portfolios with US managers Northbridge Partners and Berkeley Partners. The assets in the Longpoint portfolio are all located in industrial markets where supply is scarce and rental growth has surged. "It is a situation where the more time passes, the more under-rented it will become, and a mark-to-market strategy is an interesting way for us to create value in that sector at this point in time," says Reilly.

portfolios through recapitalization has been an incredibly effective way to build scale quickly. Over the past 18 months, we have acquired over 20 million square feet of logistics assets in this way. That is pretty good in a sector that is hard to access and relatively expensive.

Q Why is scale important for investors in this type of transaction?

Scale is a major advantage because it enables the buyer to act quickly and with a high degree of certainty. For example, if we are looking at an industrial recapitalization deal in a market that we know, and where we own assets, we are able to underwrite the portfolio very quickly with a high degree of accuracy and certainty, and provide that to the sponsor.

Because of our scale and depth of resources, the GP knows that Brookfield is going to close. For many of the sponsors in manager-led secondary deals, certainty of execution is as important as price because GPs have already put considerable effort into ensuring the existing LPs are comfortable with the process.

Another advantage of scale is that GPs like dealing with one capital provider. In the past, we have often seen two or three investors clubbing together to do a recapitalization. From an execution standpoint, sellers can feel more confident partnering with a single buyer who can write the entire check. And in the management of the portfolio going forward, it is easier to deal with one party.

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Q How do you set the right price in GP-led deals?

It entails underwriting the assets at a very granular level, meeting with management, and combining that information with our expectations for that particular asset or submarket going forward. Oftentimes, we can get in at a little bit of a discount. But unlike the traditional LP-led secondaries market, where the discount in price compensates for the lack of information available to the buyer, in GP-led deals the buyer has all the information required to be very precise in their underwriting. There may be a small discount, but the strategy is not predicated on that discount.

It is also very important to create a win-win where the selling investors are happy with the level of transparency. With all these deals, we want the existing LPs to know that they can roll over their interest into the new structure if they would like to. Price is not the only consideration, though. Fit is also important. Both parties need to live happily with each other in the new vehicle for quite some time. It is sort of like a marriage – you can definitely get it wrong. You can recapitalize a bad GP, or one that has issues, and irrespective of how good the real estate is, it can be hard to recover if you have a bad partner.

Q What can investors do to integrate ESG considerations within secondary transactions?

ESG is permeating every area of real estate, and it is part of every transaction that we underwrite. When we are looking at GP-led recapitalizations, we discuss with the manager the potential opportunities to enhance ESG across the portfolio. We deal with a number of small to midsize managers, and we are able to educate them on what investors are looking for, and then help them come up with a game plan.

For example, when we buy logistics assets, we determine whether we can undertake improvements such as installing LED lighting, solar panels and/or electric vehicle charging stations. Within the Brookfield platform, we have a large infrastructure and renewable power businesses, so we can leverage the capabilities of the organization as a whole.

Q What will be the scale of the investment opportunity in GP-led secondaries going forward?

We are seeing a large investable universe of opportunities. In the two years we have been active in the space, our global deal pipeline has ranged from $10 billion to $12 billion of GP-led deals. Even though the stats show growth in the space, we think they significantly underrepresent the size of the market. Oftentimes, the reported deals only include those with an adviser involved, and the research is usually only focused on closed-end commingled funds. But we also invest in recaps that are in funds, JVs and/or separate accounts.

Globally, the US and Europe should be the most active markets, followed by Asia. That largely correlates with the number of managers active in each region. The manager-led space will continue to evolve and become a bigger part of the market, particularly as values increase. GPs and LPs are becoming more comfortable with this approach. Where they have strong assets with the potential for additional value creation, they will increasingly consider recapitalization as an alternative exit route to selling. ■