

## Private Equity Discovers Real Estate

By Thomas Wenkstern

The words private equity have a familiar ring to diverse segments of the U.S. (and the world for that matter) due to increasing media coverage brought on by an ever expanding scope and scale of investments and the resulting creative economic destruction. Key attributes of the private equity industry underscore its growing importance:

- The top 20 firms have in excess of \$400 billion under management representing portfolio companies with almost six million employees <sup>(1)</sup>
- Private equity firms raised \$215 billion in 2006 and are projected to raise \$400 billion in 2007. <sup>(2)</sup>
- During the 1<sup>st</sup> quarter of 2007, \$197 billion of private equity driven mergers occurred. <sup>(3)</sup>
- Over 900 companies were removed from the NYSE, AMEX, and NASDAQ in 2006 by going private. <sup>(4)</sup>

With all this activity, commercial real estate has existed in three dimensions in the private equity universe: a contributor, a target, and a beneficiary.

*Contributor:* Private equity deals use liberal amounts of debt to acquire companies based upon enterprise cash flow and underlying value of assets. As a result, corporate owned real estate can be a key asset that can be pledged as collateral for debt or sold off (sometimes very quickly) to pay down debt and generate investor returns. Frequently, undervalued and excess corporate real estate is stripped out and sold to other private investors who specialize in repositioning these assets. Kohlberg, Kravis, Roberts & Company's acquisition of Toys "R" Us in 2006 and subsequent creation of a joint venture with Vornado Realty Trust to maximize the value of the real estate portfolio reflects this trend.

*Target:* With the increasing amount of private equity available, investment opportunities are becoming increasingly segmented as funds search for new asset classes. The Blackstone Group's \$38.9 billion acquisition of Equity Office Properties earlier this year is a prime example. Vornado Realty Trust was also a bidder for EOP which increased the price. Further, Blackstone's immediate flipping of a portion of the Equity Office portfolio to other investors reflects the multi-faceted role real estate can play. Other REITs have also gone private, including those that have been viewed as weak-performers in the industry. In 2005 and 2006, there were 11 deals valued at \$18.7 billion, and 23 deals valued at \$64.3 billion. <sup>(5)</sup> Finally, the recent challenges in the sub-prime residential loan market have made the troubled firms originating these loans and the loan pools interesting investment opportunities for private equity.

*Beneficiary:* Private equity has become a notable source for real estate "venture capital," mezzanine financing, and hard money loans complementing and sometimes displacing traditional real estate funding sources. Simply put, the number of sources for real estate capital has increased geometrically in the last twenty-five years and has accelerated in the last few years with substantial amounts of private equity available.

Back to the Future?

It is difficult to judge the long lasting impact of private equity on real estate based upon the activity level we have seen in the last few years. Real estate by nature is a long-term investment and some of the capital flows and transactions represent shrewd financial engineering based upon the substantial liquidity in the market place. Certainly the buyouts have created inertia and urgency for corporations to unload and/or unlock the value of their real estate holdings which can be seen as a very positive development with respect to shareholder value. The abundant real estate capital has supported increasing asset values in all commercial categories and in the majority of geographic markets, in primary, secondary and tertiary cities. It has also supported transactions that may not stand the test of time.

The U.S. continues to enjoy its longest economic expansion; one that has fueled optimism that real estate will inexorably increase in value with diminished downside risk. At this mature stage of the economic expansion however, cracks have developed in the performance of REITs and in the domestic housing market. Economic cycles still exist, and are reoccurring. Two examples come to mind. Does anyone remember the technology bust of the late 1990 and earlier in this decade? Does anyone remember the S&L debacle or interest rates rising up into the teens during the early 1980s? What all of this suggests of course is that real estate continues to be a cyclical business.

### About the author

Thomas Wenkstern is a senior vice president with UGL-Equis' Dallas office. With more than 28 years of experience in the commercial real estate industry, he specializes in management consulting, outsourcing, investment banking and real estate finance, brokerage and transaction management, site selection and acquisition, development, property and facilities management. He works with space users to provide corporate real estate and advisory services relating to strategic planning, organization design, reengineering and portfolio planning.

### Notes:

- (1) Behind the Buyouts – Inside the World of Private Equity, SEIU, April 2007.
- (2) “The Buyout Binge: Private equity firms are gobbling up everything in sight. How long can it last?”, Joseph McAfferty, CFO Magazine, April 2007.
- (3) “Deal Engines on a Roll,” Forbes, April 2, 2007.
- (4) Investment U Research Team
- (5) “Morgan Stanley Unit to Buy Crescent Real Estate,” Thaddeus Herrick and Jennifer Forsyth, Wall Street Journal, May 23, 2007.