Park Madison Partners

The case for portfolio recapitalizations

David "Mac" McWhorter, executive director of the Institute for Real Estate Operating Companies (iREOC), recently spoke with **Nancy Lashine, Robert Kohn** and **Warren Kotzas** of Park Madison Partners. An excerpt of their conversation follows.

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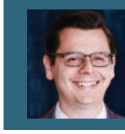

Warren Kotzas
Capital Advisor

Park Madison has become one of the premier placement agents in the industry, but I understand you are adding to your offerings, specifically recapitalization advisory. Why have you moved into that niche?

Nancy Lashine: Park Madison started in 2006 with a business model focused on matching institutional investors with real estate private-equity fund managers. We view ourselves as a bridge between the GP and the LP, having participated in the placement of over $16 billion over the past 13 years. During that time, commingled funds — particularly closed-end funds — were typically the capital structure of choice. Recently, however, a growing number of managers and investors have been looking for different types of structures. Maybe they originally invested in or sponsored a closed-end fund, but now want to transition those assets to a joint-venture structure or open-end fund, or another structure that better fits their current portfolio goals. For example, as a closed-end fund comes to an end, it is sometimes obvious that the portfolio is still performing but has not reached the full potential of the underlying value-creation plan. Instead of liquidating, the manager might determine that recapitalizing will provide the greatest optionality for their investors. So, we have evolved our business to serve the same group of clients and investors that we have been working with for all these years and whom we know well, but we are now providing incremental services and products that fit their changing needs.

How do recapitalizations fit into that?

Lashine: Recapitalizations are a natural extension of what we have always done because they allow us to provide solutions for our clients — both managers and investors — all the way through the life cycle of their investments. Given the experience of our team on both the buy side and the sell side, we find ourselves uniquely positioned to provide advice in the recapitalization space.

What exactly are you recapitalizing? How does it differ from a refinance or secondary process?

Rob Kohn: People often use the terms interchangeably, but they are really very different. Refinancing involves the debt part of the capital stack, while recapitalizations involve the equity part. Often, the recapitalization happens at a portfolio level and usually involves a new business plan. Secondaries, on the other hand, usually involve one investor buying shares from another. Nothing changes at the portfolio level.

Lashine: Recapitalizations are generally not just replacing one partner with another, as you would with a secondary. Instead, you are creating an entirely new structure and potentially resetting the business plan. Existing management would stay in place but, depending on the investor, there might be changes to GP/LP control rights. So a new structure or vehicle often has to be established for a recapitalization, which is very different than a secondary sale.

Warren Kotzas: Digging a little deeper, traditional secondaries are a standardized type of transaction that solves one type of issue: the transfer of limited partnership positions to provide liquidity to LPs in a fund, with everything within the fund structure staying the same. It provides liquidity to the LP, but not to the manager. Recapitalizations, on the other hand, are complex and refer to a series of different types of transactions, such as fund restructurings, joint-venture buyouts, strip sales and other structures. Recapitalizations require a bespoke solution that looks at the big picture and considers the overall goals of both the manager and underlying investors.

What kinds of vehicles are typically recapitalized?

Kotzas: Most often, we are advising on recapitalizing vehicles — typically structured as limited partnership closed-end funds — that own multiple assets with new or refocused business plans. If the assets are clean and the business plans are complete, the best solution is likely a direct outright sale to the market rather than a recap. Recapitalizations make the most sense when there are timing or liquidity considerations, or opportunities at the asset level that could use more time and capital to realize. For example, an operator might find that the fund has reached an end with a few remaining assets in the vehicle having below-market rents and upcoming tenant rollover. In such a scenario, additional time and investment to bring rents to market may yield better returns, but some of the investors may still prefer to exit rather than continuing the fund. A recapitalization would allow the manager to bring in new investors and capture that additional upside.

Are recapitalizations gaining in popularity?

Kotzas: We are definitely seeing a steady increase of trade volume. Just in the past 12 months we have tracked a combined total of $13 billion of recapitalization and secondary transactions. Increased volume makes sense because the market is maturing. In the past 10 years, it has moved from liquidity-motivated decisions spurred by the Global Financial Crisis to portfolio- and asset-management decisions. Recapitalizations are an effective portfolio-management tool, which can be used to rebalance exposure to different managers, operators or investors. We expect transaction volume to continue to increase as more investors enter the space.

Why would an investor want to be part of a recap rather than just going into a standard private-equity fund?

Kohn: Investors have three broad choices when it comes to private real estate fund investments. They can invest in traditional blind-pool closed-end funds, where they can underwrite the manager and proposed strategy based on past performance, without a portfolio of assets in place. They can purchase shares in the secondary market, where they can underwrite the assets and manager, but the fund is already well under way and the strategy is playing out, for better or worse. Or they can become part of a recapitalization, where they can underwrite the manager and assets, as well as be part of a new strategy based on the manager's intimate knowledge of the assets and local markets. Investors like the specificity recapitalizations can provide, especially in the current economic climate. This is a vehicle and a transaction type that allows the real estate private-equity market to be more dynamic and more liquid, delivering better results to managers, operators and investors.

How do you deal with conflict of interest when the GP is the one that gathers the new capital and sets the new strategy?

Lashine: Therein lies the opportunity for an organization like Park Madison Partners. If there was no conflict of interest, the parties could probably solve this themselves. However, because it is often complicated and involves multiple divergent interests, it usually makes sense to have someone like Park Madison involved. We shed light on the situation, consider alternative solutions, and act as a bridge between all the parties.

Kotzas: We are a neutral intermediary that makes sure that any conflicts are brought to light and dealt with. It is important that everybody can see what is going on, understands why it is happening and has the chance to understand that a recapitalization is the most appropriate solution in certain situations. You need options for each stakeholder to make the decision based on their needs and preferences. Managers could provide a rollover option, a status quo option and a liquidity option, depending on the specifics of the structures. You provide complete transparency of information; you conduct a disciplined, fair process; and then you give people a choice on what is right for them.

If somebody wants to begin a recap process, where do they begin?

Kotzas: The sponsor typically needs to start with their limited partner advisory board to discuss the merits of a recap versus an outright sale. The manager needs to have a clear answer to this, and communicate it in an effective and transparent manner. The manager's first duty is to their existing investors. So a recap needs to make economic sense to all parties involved or it typically doesn't go anywhere.

Kohn: Engaging an adviser early in the process is also crucial. Advisers can help devise the right approach, solution and communications strategy. The manager needs to define and articulate the ultimate objective, and then be able to communicate their goals and strategies to existing investors. Transparency is key to the entire process. You want to give all interested parties the information they need to make the appropriate decision. Existing investors have to consider their fiduciary obligations to beneficiaries, and potential new investors have to understand the business plan and value proposition of the restructured partnership. There are several interested parties with their own unique considerations, so managing the communication between them effectively is critical to a successful process.

When does recapitalization work best?

Kohn: Recapitalizations work best for successful vehicles that just need more time or capital after the original business plans have reached the end of their underwritten timeline or budget, and there is still value creation that can be captured either through additional time, additional capital, or both. It's not really an option for a portfolio of core stabilized assets with no remaining value left in any of the underlying business plans. Putting aside any potential structural or legal issues, a core portfolio would typically command efficient pricing through a direct sales effort, while value-add business plans allow a sponsor to demonstrate the value of a continuation vehicle.

Lashine: Real estate doesn't always fit neatly into a traditional private-equity structure. Sometimes those structures work beautifully, gains are realized and distributed in six or seven years, and everything is great. But sometimes that structure doesn't work for all of the assets in a portfolio, and it might be because it never did work. It might be because of something that happened cyclically at a point of time in the market, perhaps in capital markets, certain property types, or a specific geography. But, for some reason, that structure may not be optimal for certain real estate assets on a go-forward basis. In those situations, recaps may offer an elegant solution.

Kotzas: In the real world, all kinds of crazy things can happen with real estate assets. Recapitalizations give us the ability to pivot, react, and re-create. They allow us to access the advantages of private equity funds while adjusting for the on-the-ground realities of real estate. That makes recapitalizations a very powerful tool.

OVERVIEW

Park Madison Partners is a boutique New York-based capital markets and advisory firm for global real estate alternative investments. Since its formation in 2006, Park Madison has participated in the placement of over $16 billion in private equity capital for a wide range of real estate vehicles and strategies. Our team is experienced on the buy-side and sell-side of the real estate industry, including specialization in recapitalizations as both investment principals and third-party advisors. Our unique expertise in real estate capital markets allows us to offer highly customized liquidity solutions to real estate managers across a variety of structures.

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