Landmark Partners

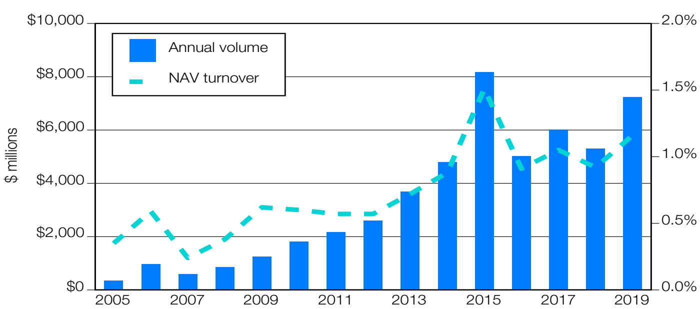
Framing real estate secondaries

A single investment thesis provides multiple liquidity solutions

A Landmark Partners' (Landmark) investor pitch for real estate secondaries a decade ago was somewhat of an existential exercise. Investors were looking to understand what exactly real estate secondaries were and why the strategy would prove to become a long-term investment opportunity. We would highlight that, in the five years leading up to the 2009 global financial crisis, $488 billion was committed to closed-end private equity real estate funds, and such a large market capitalization of illiquid assets necessitated a secondary market for investors to maintain optionality and meet their portfolio management needs. At that time, data from the private equity buyout market indicated that more than 1 percent of outstanding net asset value sold annually in the secondary market (a ratio referred to as NAV turnover). Extrapolating that data would imply that annual sales of interests in real estate private equity funds could eventually reach $2 billion, which they did by 2011.

Annual real estate secondary transaction volume has averaged $6.2 billion over the three-year period ending 2019, and institutional investors are more familiar with the real estate secondary market today than they were a decade ago. Moreover, as the secondary market has established itself over the past decade, it has evolved to address a broader range of challenges facing limited partnerships than in the past. Some of the liquidity and partnership pressures facing these investors have been exacerbated by the market dislocation caused by the global pandemic. In the following sections we provide an overview of the broad market opportunity available to real estate secondary investors today.

Real estate secondary transaction volume



Source: Landmark Partners

Limited partner solutions

Real estate secondary investors buy partnership interests in a secondary market. In its simplest form, a limited partner sells its position in a real estate fund to a secondary investor for a negotiated cash purchase price. Throughout Landmark's history, the majority of transactions have been structured in this format. However, as active management of investment portfolios has become more sophisticated, investors have looked to the secondary market for more customized liquidity solutions.

Structured transactions address a variety of seller objectives

For example, a limited partner looking to reduce its portfolio allocation to real estate might determine that it does not want to curtail its relationships with its existing general partner sponsors. For investors meeting this profile, Landmark has structured transactions where the limited partnership interests are contributed to a new venture, in which Landmark funds a purchase price to participate in the economics of the transaction through a cashflow allocation waterfall. The seller receives an upfront price and retains a partial economic interest in the fund portfolio into the future. The investor has met its liquidity or allocation objective by reducing its economic interest in the portfolio. The investor has also achieved the objective of retaining an economic interest in the portfolio and exposure to the underlying managers. This example of a structured transaction is one of several that secondary investors like Landmark employ to customize a liquidity solution for limited partners.

We have also been approached by investors looking to reduce their real estate allocation through a secondary sale, however, they were concerned they had not yet identified where to reinvest the cash purchase price. For investors facing this dilemma, we have structured transactions by which the purchase price is funded over time, either as dynamic- or fixed-payment streams. This allows a limited partner to offload its real estate fund holdings in exchange for a more regular payment stream.

In addition, limited partnership interests are relatively illiquid, lack active control positions and typically sell in the secondary market at a discount to net asset value. The timing of gain and loss recognition has also been an area of focus for secondary market sellers. To address such concerns, transaction structuring has been utilized in the secondary market to help investors manage their balance sheets, as well as gain and loss recognition.

Overall, the secondary market for real estate partnership interests has responded to meet the liquidity and economic objectives of individual limited partners through the arrangement of transactions in a variety of structured formats. The market has also gained an element of efficiency by creating solutions that seek to address the liquidity objectives of multiple limited partners through a single transaction.

Fund recapitalizations: Bulk purchases of interests from LPs

During the first five years of the economic recovery that followed the 2009 global financial crisis, investors largely used the secondary market to address needs unique to their own portfolios. Secondary market transaction volume from 2010 through 2016 largely comprised limited partner portfolio sales of individual minority interests. Within any institutional real estate fund during this time, it would not be uncommon to see a few real estate secondary sales in any given year. Limited partners largely utilized the secondary market to address their own unique portfolio management objectives.

However, as funds mature and approach their legal expiration date, a greater proportion of underlying investors expect to see near-term liquidity. This can pose an issue for funds where business plans extend beyond the legal fund term. An analysis conducted in 2018 by Landmark Partners in conjunction with Professor Jacob Sagi at the University of North Carolina's Flagler School of Business found that, on average, the 50 funds analyzed in this study were only 69 percent realized at their initial maturity date.

By 2017, there was more than $140 billion outstanding in net asset value in private real estate funds that were raised in 2010 or earlier. The desire for liquidity in many of these funds was no longer limited to a few investors per year. Investors that had invested in these funds had expected to be fully liquidated years earlier. Over the past several years, the real estate secondary market has addressed the demand among limited partners for liquidity at the end of a fund's legal term by structuring transactions to buy out limited partners in bulk through a fund recapitalization. In fact, during 2019, recapitalization of funds and property portfolios accounted for more than 50 percent of the total secondary volume for the first time on record, reaching $3.6 billion. Recapitalizations can be arranged through a variety of transaction formats. However, in many cases, investors are offered the option to stay in the partnership through an extended term, while those that elect to exit can sell to a secondary market buyer at an offered price. Such transactions require attention to ensure that extending investors, the secondary buyer, and the fund sponsor are aligned on business plan objectives and investment horizon.

General partner solutions

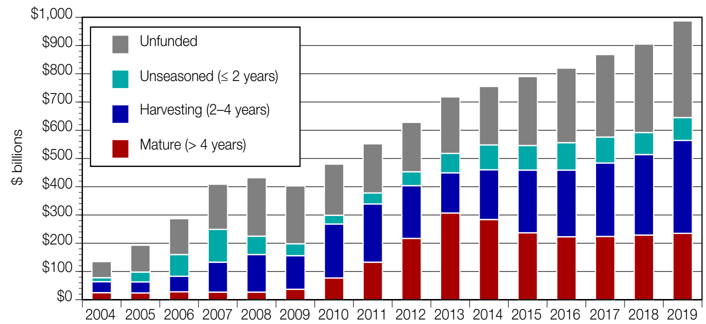
With fund recapitalizations, fund sponsors became more actively involved in assisting their limited partner investors with access to secondary market liquidity. Secondary market recapitalizations are not limited to funds. Secondary buyers have actively worked with general partners in recent years to address liquidity needs directly at the property and portfolio level.

Moreover, secondary investment activity is not restricted to the acquisition of limited partnership interests. General partners themselves have turned to the secondary market to address their own liquidity and growth capital needs. In recent years, long-dated private equity funds have become active investors in permanent equity stakes of asset management firms. However, for fund sponsors that are looking for growth capital without the sale of a permanent stake in their business, the secondary market has become a source of liquidity. In such situations, a secondary investor finances the fund sponsor's balance sheet, which typically includes its co-investment stake in funds and other partnerships, as well as promotes. Proceeds advanced by the secondary investor can be utilized to reinvest into the fund sponsor's business and seed new investment strategies.

Current environment

Illiquidity in the marketplace results in investment opportunities for secondary investors. In the context of the current pandemic, both limited partner investors as well as fund sponsors have sought relief through secondary market sales in order to manage through

Real estate funds under management



Sources: Landmark Partners, Burgiss, Preqin

dislocated capital markets. Once capital markets normalize and a recovery takes shape, investor shifts in portfolio management are likely to drive additional secondary transaction volume. Moreover, real estate funds with harvesting and liquidation periods that have been extended by the impact of the pandemic will likely find that the secondary market offers a practical way to recapitalize a fund and realign investment partners. As of year-end 2019, there was more than $560 billion of net asset value outstanding attributable to real estate funds raised from 2010 to 2018. If historical trends hold and the vast majority of these funds are unresolved at their legal maturity date, the desire for liquidity by underlying investors will drive continued transaction flow to the real estate secondary sector.

As the real estate secondary market has grown over the past decade, seasoned market participants have expanded their capabilities and resources. Landmark, for example, has continued to expand the depth of its dedicated secondaries underwriting team globally, providing for broad market coverage to advance transaction sourcing, structuring and due diligence. As we reached the late stages of the real estate market expansion in recent years, investment diligence and discipline were paramount. This will continue to be the case as global markets look to adapt to a new landscape impacted by a global pandemic. In addition to developing its transaction structuring capabilities, Landmark has also developed proprietary analytical resources by constructing public and private real estate benchmarks to evaluate real estate performance. Through further investment and innovation, we look to facilitate the ever-expanding range of liquidity solutions provided by the real estate secondary market.

CORPORATE OVERVIEW

Landmark Partners specializes in secondary market transactions of private equity, real estate and infrastructure investments, with more than $28 billion of committed capital as of June 30, 2020. Founded in 1989, the firm has one of the longest track records in the industry and is a leading source of liquidity to owners of interests in real estate, real asset, venture, mezzanine and buyout limited partnerships. Landmark has positioned itself to capitalize on inefficiencies in the secondary market, through the development of a well-tenured investment team, in-house research, cross-platform resources and an extensive network across the investor and fund sponsor communities. Landmark has completed more than 685 transactions in its 30-year history and acquired over 2,400 partnership interests, managed by more than 830 general partners, as of June 30, 2020. Landmark Partners has more than 140 professionals across six offices in Boston, Dallas, Hong Kong, London, New York and Simsbury, Conn. **www.landmarkpartners.com**

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