SummerStreetAdvisors

Private Wealth Investors Find Opportunity in Real Estate

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When stock market and hedge fund investments turned down during the recession, family offices and other private wealth nvestors turned to commercial real estate as a way to get a favorable income stream and long-term appreciation. The volume of family office investment in the U.S. grew dramatically, fueled by both foreign and domestic investors, who initially found a buyer's market. But what has happened to family office investment now that institutional players like pension funds and sovereign wealth funds are bidding up prices and pushing down cap rates?

Are private investors getting forced out of direct real estate investment? In past cycles, the answer might have been 'yes,' as family offices tended to fulfill their real estate allocation by investing through intermediaries like hedge funds. Property owned directly by a family office was either a legacy of a real estate developer patriarch, or smaller assets close enough to family members for drive-by inspections. But those old rules appear to be changing. As private wealth grows and family offices become more sophisticated in their approach to investment, they're competing effectively with institutional buyers for commercial real estate deals, in part by adopting some of the strategies of institutions.

The universe of private investment capital is growing due to increasing numbers of ultra-high-net-worth individuals (UHNWIs), defined as those with assets totaling $30 million. There are 172,850 UHNWIs worldwide today, an increase of 61 percent over the past decade, as 65,000 people have become ultra-wealthy since 2004, according to Knight Frank's Wealth Report. About 1,180 people crossed the $100-million-dollar mark in 2014 alone, bringing the worldwide total of "centa-millionaires" to 38,280. And the number of billionaires, now at 1,844, has increased by 82 percent over the past decade.

All that investment capital has to go somewhere, and a lot of it is going into real estate. Direct property investment accounts for 14 percent of private wealth investment globally, with regional variations ranging from 12 percent in North America to 16 percent in Europe, according to Bloomberg Brief's Special Report on Family Offices.

Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

Nearly 40 percent of wealth managers surveyed by Knight Frank said their UHNWI clients increased allocations to real estate in 2014, when private wealth accounted for approximately 25 percent of all commercial real estate acquisitions. And the pace of private investment is expected to grow even more in the face of heightened competition for prime assets.

This is a new trend, unlike past economic cycles, when private investment was concentrated on the recovery phase and scaled back when institutions bid up asset prices and reduced achievable risk-adjusted returns. What's driving the resiliency of private wealth investment this time around? Several of the reasons are apparent, such as the increase of private wealth for investment and the desire for relatively stable long-term yields that real estate provides. But other, less-obvious factors illustrate the evolution of family office investment to resemble institutional approaches in many ways:

• **Wider geographic focus** – In the past, private investors liked to keep their real estate investments close to home, where they could keep up with the nuances of property markets. Today, with global access to local-market information, family offices are more comfortable than ever in making cross-border investments. This is especially important in the current global economic environment, as investors in much of Asia, Eastern Europe and the Middle East are concerned about the strength of their regional economies and looking to North America as a safe haven to preserve their wealth. Knight Frank reports that UHNWIs in Europe control $6.4 trillion, and those in Asia control $5.9 trillion, but private capital from those regions is increasingly focused on North America, where UHNWIs control $5.5 trillion.

• **Broader property types** – Historically, UHNWIs concentrated their investment on Class A office buildings, retail and apartment buildings, particularly in large cities. These assets were viewed as safer for the long term—and easier for investors to understand—than less-popular property types in secondary and tertiary markets. Today, family offices have in-depth access to market data and better analytical capabilities to make UHNWIs comfortable with a wider range of property investments.

• **Socially responsible investment** – When it comes to responsible investing, it's difficult to say whether private investors are following institutions or the other way around. There have always been private investors with a social dimension to their strategy, such as funding a community investment designed to spur local economic recovery. And there have always been pension funds that favor union-built developments for investment. Whichever type of investor was "first," responsible investment strategies are increasing on both sides, particularly in terms of energy and sustainability features, which have been shown to increase asset value and cash flow in addition to being socially responsible.

• **Greater control over asset decisions** – Institutional investment managers are seeing a gradual shift in institutional capital from commingled funds to separate accounts that carry higher fee structures but give them the final say on acquisitions and dispositions. A similar trend is occurring in the world of private wealth as family offices increasingly shift away from hedge fund investment in favor of vehicles that give them greater control over buy and sell decisions. In addition, the past 10 years has seen the rise of hybrid family office structures that often enable individual family members to choose how some or all of their capital is invested.

Another emerging trend—crowdfunding—underscores the idea that private investors are increasingly comfortable making their own investment decisions. In the past few years, several crowdfunding platforms have sprung up, and the concept has proven to be workable. Certified investors review the prospectus for a potential investment and decide whether to participate before the investment window opens. Crowdfunding sponsors have reported raising millions of dollars in a matter of minutes after its pool of investors had analyzed the opportunity in advance.

All these trends point to a larger mega-trend among private wealth investors: a willingness to be more knowledgeable and more engaged in real estate decision-making. Motivations vary: Investors may believe they can achieve higher overall yields by cutting out middlemen, they may want a voice in the acquisition process, or they may simply like being involved. Whatever combination of motives is in play, it's clear that family offices and similar private wealth vehicles will continue to increase in importance in the commercial real estate investment market.

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