What is Real Estate Private Equity?

Private equity deals not only involve the buyout of traditional companies but also involve investments in real estate entities. This is known as real estate private equity (REPE).

Real estate private equity firms raise capital from outside investors, called limited partners (LP). They use this capital to buy and develop properties, operate, and improve them, and then exit out of them to realize a return on the initial investment. Limited partners include pension funds, endowments, insurance firms, family offices, high-net-worth individuals, among others, and these investors bring together the majority of the equity required to fund the investment.

Real estate private equity firms generally focus on either residential real estate, which includes multifamily (apartment complexes or apartment buildings), or commercial real estate, which includes offices, industrial, retail, and specialized properties like hotels. When private equity firms decide to invest in residential real estate, the strategy is to buy the asset, complete capital improvement projects, hold the asset until gains have materialized and the value of the asset has appreciated. During this hold period, firms will typically rent out apartment units to individuals to generate rental income (DeChesare).

Relevant Terminology

<u>Class A real estate:</u>
Class A assets include top-quality buildings that are typically built within the last 15 years. However, certain assets maintain the Class A status even after the 15-year threshold through significant renovations that modernize the property and bring it in line with other modern assets in the market.

<u>Class B real estate:</u>
Class B assets are older than Class A assets. Hence, Class B investment opportunities present relatively higher risk. Generally average in quality, most Class B assets don't offer the same luxurious amenities and are older than 15 years. Although these assets normally provide adequate facilities, they tend to be slightly out of touch and lack modern building finishes and upgraded amenities. Class B assets generate average market rents.

<u>Class C real estate:</u>
Class C assets are on the opposite end of the spectrum from Class A assets. Class C assets are at least 20 years old and in need of substantial capital investment for repairs and renovations; hence these assets normally collect lower-than-average rents.

<u>Cap Rate:</u>
The cap rate indicates the rate of return that one can expect a real estate investment to generate. This return measure is computed by dividing the annual net operating income a property is expected to generate by the purchase price of the property or the total capital used to acquire the property. Expressed as a percentage, the metric is used to estimate the investor's potential return on an investment. The cap rate is also typically used as a comparison of the relative value of similar real estate investment opportunities.

<u>Net Operating Income:</u>
Net operating income, or commonly referred to as NOI, is one of the most important measures for real estate investors to know how to correctly calculate. NOI is used to assess the profitability of a real estate asset after subtracting necessary operating expenses but before taking debt service and capital expenditures into consideration. Since depreciation is a non-cash expense and NOI is a cash metric, depreciation is also not factored into the equation for NOI.

<u>Interest Rate:</u>
Interest rate is expressed as a percentage of the principal, the amount loaned, that a lender charges a borrower. The term interest rate can also apply to the amount earned at a bank or credit union from a savings account or a certificate of deposit (CD).

Two Major Transactions in the Real Estate Private Equity Space

Hilton Hotels Transaction

In 2007, The Blackstone Group acquired Hilton Hotels for $26 billion, taking the company private. The Hilton Hotels transaction was an all-cash transaction by Blackstone's Real Estate and Corporate Private Equity funds where Blackstone acquired Hilton for $47.50 per share of outstanding common stock, presenting a premium of 40% over the closing share price a day prior to the transaction. Typically, when private equity transactions are made with a premium, the premium is paid taking into account the large amount of value that will be created once synergies are realized.

As Hilton Hotels is a leading global hospitality company with an unparalleled group of brands including Hilton, Conrad Hotels & Resorts, Doubletree, Embassy Suites, Hampton Inn, Hilton Garden Inn, Hilton Grand Vacations, Homewood Suites by Hilton, and The Waldorf Astoria Collection, the acquisition adds value to Blackstone's extensive portfolio of hotels and resorts. Between 1992 and 2007, Blackstone was the largest private investor in hospitality worldwide.

Both Hilton Hotels and Blackstone's executives see great potential in the private ownership opportunity. While Stephen F. Bollenbach, Hilton's Co-Chairman and CEO, said the company's "priority has always been to maximize shareholder value" and that this transaction provides compelling value for shareholders with the significant premium that Blackstone is providing for the acquisition, Jonathan Gray, a Senior Managing Director at Blackstone, believes it would have been "hard to imagine a better strategic fit than Hilton with its world-class people, brands, and network of hotels and that the transaction will create value for both Blackstone and Hilton as Blackstone invests in the company and works with Hilton's current owners to continue to grow and enhance the premier global hospitality business.

Two Major Transactions in the Real Estate Private Equity Space

(Hilton Hotels Transaction continued)

As Blackstone deems Hilton as an important strategic investment with numerous value-add opportunities, there were no significant divestitures anticipated in this transaction.

Company acquisitions require a couple of key players, including financial advisors and legal advisors, to assist both the buyer and the seller throughout the process of a transaction. During this transaction, Blackstone's financial advisors included Bear Stearns, Bank of America, Deutsche Bank, Morgan Stanley, and Goldman Sachs, and the legal advisor was Simpson Thacher & Bartlett LLP. Hilton's financial advisors were UBS Investment Bank and Moelis Advisors, and the legal advisor was Sullivan & Cromwell LLP.

After managing Hilton Hotels for 6 years, Blackstone exited by taking the firm public and returning to the New York Stock Exchange for public ownership. In its initial public offering (IPO), the chain raised $2.35 billion marking the largest IPO by a hotel firm of its time.

Multifamily Portfolio Transaction

In January 2016, real estate private equity firm, Starwood Capital co-invested with SOF X to acquire an institutionally owned, Class A multifamily portfolio that included assets in South Florida, Denver, Washington, D.C., Seattle, and the Inland Empire in California. The portfolio included 72 garden and mid-rise assets with 23,262 units at the closing of the sale but operated as 66 distinct assets post closing. As a portfolio with Class A quality assets, the properties required minimal deferred maintenance. At its $5.4 billion purchase price, the portfolio acquisition was the largest non-hotel acquisition in Starwood Capital's history.

A Few Firms in the Real Estate Private Equity Space

Starwood Capital Group

Founded in 1991 in Greenwich, Connecticut by Barry Sternlicht and Robert Faith, Starwood Capital Group is a private investment firm with a focus on global real estate. The firm currently holds an AUM of approximately $115 billion and is currently managed by Barry Sternlicht. With over 4000 employees in 16 offices worldwide, the firm has raised over $70 billion of capital and invested in over $200 billion of real estate properties in more than 30 countries. Starwood Capital is headquartered in Miami and has additional office locations in Arlington, Atlanta, Chicago, Dallas, Greenwich, Los Angeles, New York, San Francisco, D.C, Amsterdam, Hong Kong, London, Luxembourg, Sydney, and Tokyo. Starwood Capital has earned global recognition for its private equity real estate business and has won countless awards over the past decade including one for Global PERE Residential Investor of the Year.

GID

GID is a privately held, vertically integrated real estate firm that owns and operates a portfolio of multifamily, industrial, and retail assets and develops mixed-use projects in major U.S. markets. Currently, GID's existing and development properties are valued at over $28.5 billion; in other words, the firm currently has close to $29 billion in assets under management (AUM)

*The Blackstone Group and Warburg Pincus are two other private equity firms that have a real estate investment arm.

Real Estate Games

WORD SEARCH

A	X	A	G	I	B	M	E	M	N	F	U	S	D	W
W	D	V	Z	Z	K	W	K	R	J	X	O	F	J	W
I	L	H	W	Y	M	R	R	N	O	H	Y	O	P	L
N	R	R	Y	G	L	B	E	L	E	A	K	G	R	R
T	D	E	X	V	V	A	T	E	I	N	C	T	R	J
E	I	Y	V	C	V	S	U	C	V	J	Q	M	E	I
R	Q	L	H	E	G	H	R	L	Q	N	Q	O	A	R
E	T	M	X	F	N	R	N	Q	U	K	T	R	L	R
S	R	J	V	Y	R	U	S	N	M	L	D	H	E	R
T	A	L	H	F	Z	A	E	P	I	C	T	E	S	R
R	N	M	T	N	Z	P	T	M	T	H	S	X	T	N
A	S	U	D	B	R	C	J	T	A	J	J	K	A	P
T	A	L	K	W	V	F	K	K	X	S	K	E	T	N
E	C	T	R	N	P	A	Q	S	W	W	P	O	E	X
F	T	I	B	W	V	T	C	A	E	B	I	G	L	Q
X	I	F	A	F	G	X	R	A	C	O	U	N	M	J
Y	O	A	H	C	S	O	H	L	N	O	L	D	H	N
G	N	M	R	S	V	O	S	B	N	C	G	C	G	E
L	W	I	E	T	F	G	J	A	K	V	Y	N	V	T
R	P	L	B	M	V	T	Q	H	E	W	M	R	S	I
F	H	Y	I	N	V	E	S	T	M	E	N	T	S	N
A	W	Z	U	W	D	L	M	U	B	P	H	X	B	C
J	Q	C	A	P	R	A	T	E	T	T	F	S	G	O
A	M	H	C	S	J	M	U	P	J	T	L	E	A	M
Q	X	T	P	U	Y	F	U	U	K	M	K	B	K	E

REAL ESTATE
INVESTMENTS
REVENUE
VACANCY
NET INCOME
RETURNS

TAX
CAP RATE
INTEREST RATE
IRR
TRANSACTION
MULTIFAMILY

Real Estate Games

TEST YOUR KNOWLEDGE WITH TRIVIA

1. Which of the following is a return metric typically used to assess an asset's return potential and involves reviewing the annual operating income relative to the capital invested for the purchase of a real estate asset?

- Interest Rate
- Cap Rate
- Revenue
- Net Income

2. In January 2016, what two firms co-invested to acquire an institutionally owned, Class A multifamily real estate portfolio with over 23,000+ units across 70+ garden and mid-rise assets?

- Starwood Capital and SOF X
- Magnolia Capital and Goldman Sachs
- Resource REIT and BREIT
- Brookfield Asset Management and The Carlyle Group

3. What is the real estate private equity firm that operates a portfolio with multifamily, mixed-use, and industrial assets with close to $29 Billion in AUM?

- Perella Weinberg Partners
- GID
- Oaktree Capital Management
- Invesco Real Estate

4. Which of the following types of real estate investment opportunities present the highest level of risk as well as the highest potential return (the higher the risk, the higher the potential return)?

- Class A
- Class B
- Class C

Real Estate Games

TRIVIA ANSWER KEY!

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