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Secondaries & Recapitalizations

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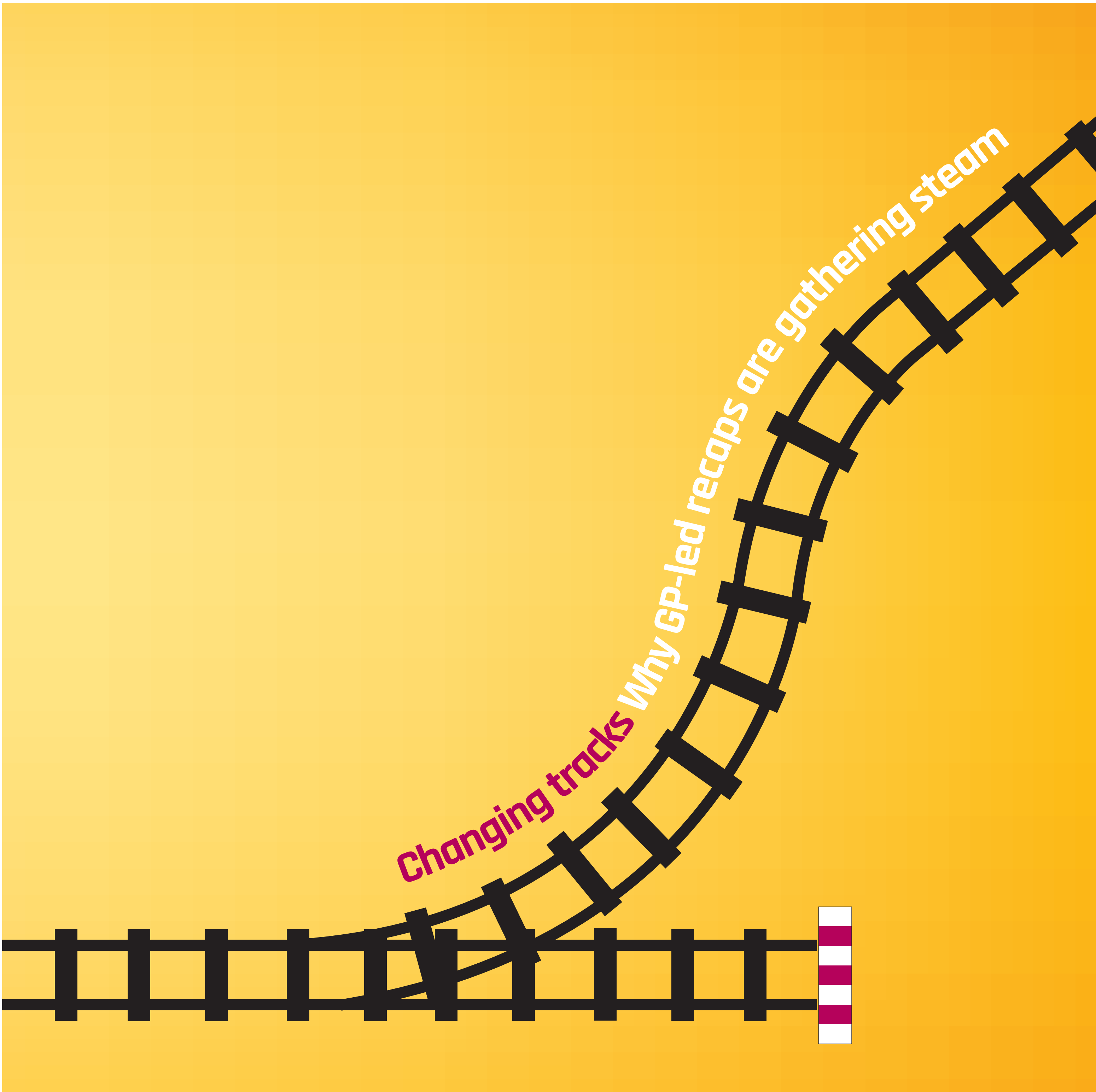
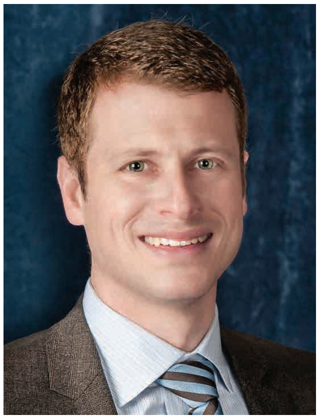


KEYNOTE INTERVIEW

Why investors should come first



While fund or portfolio recapitalizations have proven their strategic worth for GPs, such deals work best when all parties achieve their goals, say Nancy Lashine, Robert Kohn and Warren Kotzas at Park Madison Partners

New York-based Park Madison Partners, a capital markets and advisory firm for global real estate alternative investments, serves as an adviser to sponsor-led private real estate recapitalizations. *PERE* spoke with Nancy Lashine, managing partner and founder of the firm, along with Robert Kohn, partner, and Warren Kotzas, capital adviser, about the latest trends in recap deals, and why existing investors are the most important part of the puzzle.

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Q What's behind the recent growth of sponsor-led recapitalizations in the private real estate market?

Nancy Lashine: For the traditional commingled fund managers who are general partners in the structure, the five- to 10-year closed-end fund vehicle is inflexible, by design. There are times when world or market events mean the fund structure doesn't work well for the property, and it makes sense to consider a fund or portfolio recap.

Giving investors the flexibility to choose – exit or remain invested – can be very desirable. For example, when the hospitality industry was shut down during the pandemic, if you had hotel properties that were going through a renovation process and were expected to be realized at a certain point in time, you effectively faced a one- to two-year hiatus in which the business plan was completely turned on its side. For some investors, their expectations for those properties and that manager may have changed.

Alternatively, for sponsors or operators who have never raised a discretionary commingled fund, a recap could make a lot of sense if the sponsor is willing to share certain controls and not have full discretion. They can look to institutional investors who seek

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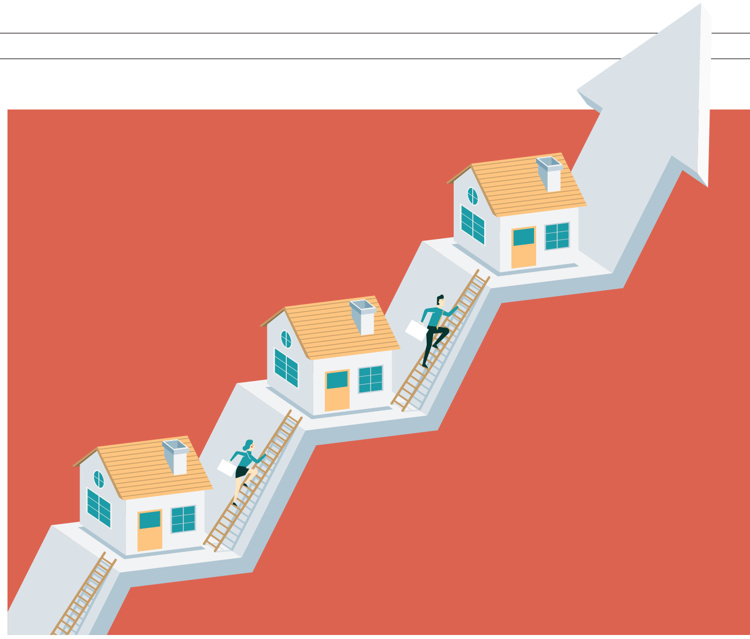

specified portfolios and build the institutional track record required for a fund later down the road.

Warren Kotzas: Recaps provide more flexibility for sponsors seeking to monetize assets and return capital to investors. If a sale is like a hammer, then a recap is the whole toolbox. You can look at the situation and do what's right by the assets, what's right by the investors, and what's right by the sponsor.

Q What dynamics will continue to drive that growth?

WK: The recap market has gone from single-digit billions of dollars to tens of billions in just the past couple of years. The amount of capital raised in private markets for real estate has also grown over time, and ultimately, the more capital that's raised on a primary basis, the more recaps you'll see.

One driver of future growth in this market is that sponsors want to hold high-quality, hard-to-replace assets for longer. They want to be able to unlock more value in the assets, achieve scale and give their investors more options. Understanding of these transactions and the rigor of the process is increasing, which makes it easier to transact and provides more access to this market.

Q How have rising interest rates affected the real estate secondaries market?

Nancy Lashine: We think rising rates will lead to further growth of the real estate secondaries market. If you have assumable debt in a secondaries transaction, it can add value to the transaction that you wouldn't otherwise find if you had to source new debt. In a time of rising rates, pre-existing debt with favorable terms is effectively an asset within an asset. In these scenarios, it's possible for the new investor to get an even better return, all else being equal.

Rising rates can also unlock new potential options for a sponsor transitioning their investor base from high-net-worth investors to institutional capital, for example. The new institutional partner can help source debt for the new partnership and access those capital markets at a scale that the sponsor otherwise could not. What's more, if you execute a recapitalization with a large institutional partner, they are going to have more credit and buying power in the debt markets, driving better rates and terms.

There's also more advised capital in the market with a clear mandate to invest in recaps, and those groups are specifically looking for immediate access to transactions. So, the volume of capital available for recaps is dramatically increasing.

Q Why is the adviser's role important in a recapitalization?

Robert Kohn: The adviser should achieve a win-win-win outcome for all constituents: the GP, the existing LPs and the new LPs coming into the deal. You need to understand the motivations of the sponsor, you need to understand the motivations of the existing investors, and ultimately you need to understand what the market will think of those assets and how they'll react to the potential recapitalization.

A good adviser will let the sponsor know if there's an actual deal to be made, and if the fact pattern of the portfolio they're looking to bring to market actually fits the market expectations for a recapitalization. Advisers need to put in a lot of time, energy and effort upfront, because you have to underwrite and diligence the real estate. You also have to understand the dynamics between the sponsors and the investors, the potential outcomes for the existing investors, maintain good communication with investors along the way, and make sure that everybody leaves that transaction feeling good about it.

We're huge fans of running a transparent process. If everyone knows what's happening and you keep communicating throughout, you'll likely end up with a highly efficient and well-executed transaction.

Q What should be the GP's key motivations when undertaking a recapitalization?

WK: The existing investors come first. The sponsor must think about the objectives of the current vehicle. Can they achieve those objectives in a recap process? Second, they should consider the rationale for the recap. There are obvious situations when a recap really makes sense. For example, you may have a multi-phase development where it's clear that the follow-on phases will be successful. That rationale then needs to be communicated clearly to the current investors, explaining why a recap will deliver value and provide more options.

The third factor is what the sponsor is trying to achieve with the recap. Sponsors want to realize returns more quickly and capitalize on that success. The sponsor will align with a new capital partner as part of a longer-term strategy, or because the assets are just irreplaceable. This can often act as a seed portfolio for a new relationship with a new investor. And sometimes, tapping a custom capital solution creates a better outcome than just a refinancing or a sale.

Q When do recapitalizations work best?

NL: When the sponsor can achieve their goals and the current investors can achieve their goals, that's when a recapitalization works best. An investor might want to manage its portfolio allocation, to move from one asset class to another more quickly than the investment vehicles allow. Sometimes the LP or investor says: "Hey, I think there's more potential value creation here and I don't want you to sell these assets. I can't replace them."

Duration can also present an issue as time goes on. The sponsor and the investor should be aligned when there's a next level of value creation, or in a situation where there's more of a challenging asset – perhaps when it's out of the promote and there's a desire to reset incentives.

Q Are recapitalizations typically focused on the 'best' and 'worst' assets?

WK: Yes, there is some concentration on both ends of the performance range. On the one end, there are the assets that have really outperformed – you could realize those gains now, or there's still a lot more that could be done. On the other end, you have the more challenging assets that are good assets, but they need more time and capital for their value to recover – more than the current vehicle can provide.

Ten years ago, it was the more challenging assets that were being recapitalized. Now, it's likely that three-quarters of them are the success stories with more value to unlock, and the remaining quarter are the more challenging assets that need more time and capital.

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> WARREN KOTZAS

Q What are the complexities investors face when evaluating a recap opportunity?

RK: The biggest complexity is the inherent conflict of interest. The sponsor is both a buyer and a seller at the same time. This is what's on investor minds when a potential recapitalization materializes. The way to resolve that is to make sure the recap is in the best interests of the existing investors, through process, transparency, communication, and creating competition around pricing.

Another complexity is the structuring: what's in place, what approvals are needed, how will the continuation vehicle be structured, and what will be its goals? It needs to be set up for success for the new investors, as well.

A third complexity is due diligence. You're usually dealing with large portfolios with complex business plans. In addition to a sale where you're underwriting the assets, you also are underwriting a new partner, and platform. Part of the diligence is understanding the motivations and expectations of the existing investors and being sure those expectations can be met.

Some opt to engage a third party to run a fairness opinion to look at the process and evaluate whether resolving the conflict of interest is being conducted in a rigorous way. In private equity secondaries, more than 90 percent of transactions involve a fairness opinion, compared to less than 20 percent for real estate secondaries. But it's growing – a sign of a maturing market. This boosts confidence in the process from all sides. ■