

## Private Equity Real Estate Investing Booms in Emerging Markets

Perhaps no image better captures the sense of boom time in emerging markets than the fleets of construction cranes crowding the skyline that are now a common sight in cities such as Beijing, Moscow and Dubai. In dozens of developing countries around the world, the real estate environment is being rapidly transformed as malls spring up to cater to new consumers, home ownership expands with growing middle classes, and rapid economic growth stirs demand for office space, distribution warehouses, hotels and apartment complexes. In one real estate sector, office development, the five most active cities in the world are all in emerging markets: Moscow, Dubai, Beijing, Shanghai, and Johannesburg.<sup>1</sup>

The opportunities in emerging markets real estate are attracting a host of investment firms, developers and services providers, including global players such as Goldman Sachs, Merrill Lynch, JP Morgan, Tishman Speyer and Cushman Wakefield. A category of investors in this arena of particular interest are private equity real estate firms. Though the term is relatively new and inconsistently applied, private equity real estate generally has three components: 1) investing to add value to real estate assets or companies; 2) investing via privately negotiated equity stakes; and, 3) investing from a private-equity-like closed-end fund. Private equity real estate is generally a higher-risk and higher-return approach than public real estate (i.e. via REITs or other listed securities) or passive private investment in real estate assets, which is typically motivated by yield and a hedge against inflation, rather than value enhancement.

Private equity real estate is an up-and-coming industry. Firms raised US\$59bn in fresh capital in 2006, a 50% increase over 2005, according to the periodical *Private Equity Real Estate*. *Private Equity Intelligence* puts the 2006 total at US\$68bn raised by 102 funds. Many of the world's largest institutional investors, including CALPERS, CALSTRS, GIC, ABP, Pennsylvania Public Schools Retirement System, and Ontario Teachers, are active backers of private equity real estate funds. Best estimates suggest that private equity real estate currently accounts for roughly 10% of global real estate investing<sup>2</sup>.

A growing percentage of this private equity real estate capital is targeting emerging markets, via either dedicated funds or global funds with an emerging markets component. The on-line news service Prequin Real Estate estimates that 25% of the funds raised

through Q2 2007 will be invested outside of Europe and North America, nearly double the 2006 share of 14%.

### Adding Value to Assets and Companies

Fundamentally, private equity real estate firms invest in, and try to add value to, real estate assets and real estate-related companies. In developed countries, the emphasis is often on refinancing or repositioning existing assets, one recent trend being the privatization of REITs trading below the value of the underlying properties. In emerging markets, by contrast, greenfield development is an important theme. In many emerging markets, such as India, China, and Russia, real estate private equity firms are teaming up with developers to build new residential complexes, IT parks, malls, hotel chains, and even entire townships. Some of these initiatives are extraordinarily ambitious. Indian firm **DLF Group**, for example, focuses on building whole towns from the ground up, and the firm is currently raising \$10bn fund for two 20,000-acre townships in Gurgaon and the South Maharashtra/Goa Region.

One of the leading private equity real estate firms investing in assets in emerging markets is **Macquarie Global Property Advisors**, which is minority-owned by the Macquarie Bank Group. Recent emerging markets investments from MGPA's 2005 vintage, US\$1.3bn Fund II include a US\$206m office, retail and hotel portfolio in Kuala Lumpur; office towers and residential complexes in Poland; and a prime office complex in Shanghai. "We take a very hands-on role in the management of our real estate investments, generally focusing on fixing and enhancing the assets to ensure we deliver maximum returns to our investors," Andrew Wood, Chief Investment Officer for MGPA told *Emerging Markets Private Equity Quarterly Review*. "There are many ways in which we can add value, such as applying a focused leasing and expense reduction strategy or undertaking development or redevelopment plans. In addition, our investment plans focus on driving returns through efficient capital and financial structuring."

Where private equity real estate most closely resembles traditional private equity is in investments into real estate related companies, such as developers and home builders. Sonny Kalsi, Global Co-Head of **Morgan Stanley Real Estate Investing**, explained the attraction of this approach in an interview with *EMPEQR*: "When

<sup>1</sup> Colliers International Global Office Real Estate Review, 2006

<sup>2</sup> Estimate based on the figure for 2006 global direct real estate investing of \$600bn from "Real Estate Industry: An Overview" published by RREEF Real Estate.

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you buy a real estate asset, you are putting a stake in the ground and saying this is where we want to be for five or ten years, this is going to be the desirable location. But in emerging markets it is not always established where the intersection of Main and Main is." By contrast, said Kalsi, investing in a developer provides diversification across the range of projects the developer is pursuing.

Morgan Stanley recently closed the largest ever private equity real estate fund, the US\$8bn MSREF VI International. The fund targets Japan, Western Europe, Australia and emerging markets, including China, India, Russia, Turkey and Latin America. Morgan Stanley Real Estate invests in both assets and companies and has a global portfolio of US\$68bn in real estate assets.

E Davison ("Dave") Hardman, who leads the global private equity real estate practice at **Warburg Pincus**, told *EMPEQR* that, "Like our private equity brethren, we are very focused on investing in entities where we can enjoy the benefits of growing with our portfolio company... We are looking for an investment thesis, not necessarily an asset, and that means partnering with an entity that can execute on that thesis."

Warburg Pincus, which closed the US\$1.2bn Warburg Pincus Real Estate I, L.P in October 2006, expects to commit 50% of that total to emerging markets and has already completed deals in business hotel companies in India and China, and residential property developers targeting high-end consumers in China.

"It's a lot harder to buy companies than buildings," said Morgan Stanley's Kalsi, which, according to Kalsi, has meant less competition and "attractive prices for investments in companies in recent years." Kalsi emphasized the importance of finding "best of breed" investee companies with a strong track record of previous developments, a substantial pipeline of future projects—and integrity. "There are usually other guys who've been able to get things done quicker in these markets, but doing things the right way usually turns out to be a better investment," he said.

When real estate private equity firms invest in developers, they are providing the equity capital that can finance further developments and land purchases, and they are betting that the developer will gain the scale and the brand to achieve competitive advantage. A firm that particularly focuses on building strong portfolio companies is the pioneering emerging market private equity real estate firm **Equity International**, chaired by real estate mogul Sam Zell. Gary Garrabrant, CEO of Equity International, told *EMPEQR* that when the firm launched in 1998, he and Zell planned to focus on investing directly in property. "We quickly found that being a direct property investor in emerging markets was a dumb idea, because we didn't have a chance at competitive advantage relative to local players. At the same time, we realized that we do

have competitive advantage, based on our experience in the US, in building companies that can be top performers at everything having to do with real estate."

Equity International has raised three funds of more than US\$300m each, and across the three funds has a portfolio of 15 companies in Argentina, Brazil, China, Egypt, Mexico, and Peru, with an investment in India expected soon.

Investing in companies means looking for a return on that investment via a sale or listing of the company. Happily for private equity real estate firms in emerging markets, investor appetite for real estate company IPOs has been very strong in recent years. Noteworthy examples include the Mexican homebuilder Homex, and the Brazilian developer Gafisa, two Equity International portfolio companies that have had very successful IPOs in recent years. Whether the IPO path will remain as accommodating in the future is another question, depending on the volatility of emerging market stocks as a result of the sub prime credit crunch, and given that many emerging markets now have a full supply of listed real estate companies; Brazil, for example, now boasts 15 listed home builders.

## The Attraction of Emerging Markets

Private equity real estate investors point to a set of strong fundamental economic factors driving the opportunity in their sector. An obvious driver is strong economic growth, averaging three to four percentage points higher in emerging markets in aggregate than in industrialized nations since 2002. Compounding the high growth are demographic trends, such as the huge rural-to-urban migration taking place in China and the significantly younger populations in most emerging markets. A third factor is the low starting point in terms of existing real estate development. The entire office space market in India, for example, was estimated in late 2006 at 60 million square feet, compared to 400 million square feet in New York City alone<sup>3</sup>.

"The homebuilder companies we've invested in are experiencing literally unlimited demand for affordable housing," said Garrabrant of Equity International.

Adding to this benign environment are significant improvements in the availability of mortgage financing in various markets and, a related development, declining interest rates in many of those markets. Phil Fitzgerald of private equity real estate firm **Paladin Realty** noted that when he started investing in real estate in Latin America in the 1990s, "The longest mortgage available was seven years, typically from the developers themselves; today, homebuyers in some markets can get 20- to 30-year mortgages from private banks, with a streamlined application process and quick approvals."

<sup>3</sup> "Why U.S. Investors are Building their Hopes on Indian Real Estate" India Knowledge@Wharton, Oct. 2006

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Interest rates in key emerging markets have been on a steady decline for several years, making mortgages more affordable for homebuyers, and financing more available for development. The country where rates have moved most dramatically is Brazil. Antonio Bonchristiano of **GP Investimentos**, a private equity firm that has made several real estate company investments in the country, said, "Three years ago, capitalization rates [the ratio between the cash flow of an asset and its capital cost] in Brazil were 12% and interest rates were 25%, which made financing real estate development impossible. Cap rates have stayed at the same level, and we can now borrow for 11% or less."

A final factor that is helping private equity real estate investors in emerging markets is improved transparency in real estate markets and regulatory environments. The real estate services firm Jones Lang LaSalle has been tracking transparency in commercial real estate around the world since 1999 via the Lang LaSalle Real Estate Transparency Index. The Index features market-level comparisons across a number of indicators of transparency, including: accurate market and financial information; reliable performance benchmarks; enforceable contracts and property rights; clarity regarding the taxation and regulation of real estate; fair treatment in the transaction process; and ethical standards among professionals hired to transact business. The 2006 edition of the Index noted that: "Since the first publication of the Jones Lang LaSalle Real Estate Transparency index in 1999, we have charted gradual improvement in nearly all of these areas. Progress has been espe-

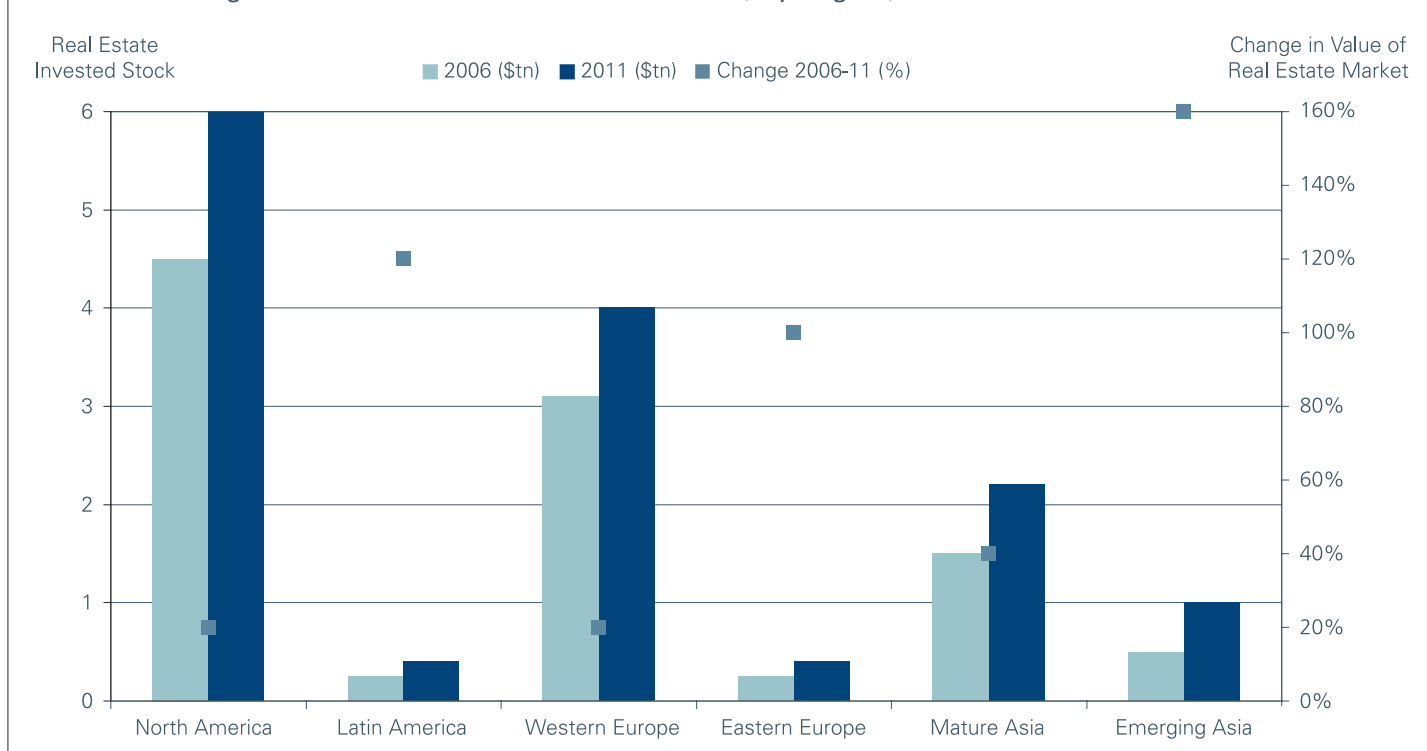
cially rapid in the last two years, with the most dramatic changes taking place in emerging markets like Brazil, India, Mexico, Romania and Turkey."

The combination of these factors—high growth from a low base, attractive demographics, declining interest rates and increased transparency—puts emerging markets real estate on an extraordinary growth trajectory. A study by RREEF, the real estate and infrastructure arm of Deutsche Bank, projects that the real estate market in emerging markets will increase by more than 100% over the next five years, growing from the current 7% of the global market to 13% by 2011. (See Exhibit 1.)

## New Targets

Some private equity real estate firms have concluded that these attractive fundamental factors are likely to be found not just in the major target markets such as India and China, but also further a field. Equity International, for example, sees opportunities in the Middle East and North Africa, where the firm has already made one investment in a homebuilder in Egypt. The firm **International Housing Solutions** is raising a fund that will focus on building affordable housing in South Africa and Jordan, two markets where the firm sees "less competition, an emerging middle class, tremendous housing shortages, and governments that are very interested in addressing the housing issues," said Chief Operating Officer Ursula Powidzki.

Exhibit 1: Changes in Value of Global Real Estate Market, by Region, 2006-2011



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## Exhibit 2: Noteworthy Private Equity Real Estate Funds, Recently Closed or In the Market

Firm	Recent Fund Name	Geographic Focus	Recent Fund Size (US\$ millions)	Fund Status	Close date
Actis	Actis India Real Estate Fund	India	300 target; 100 close	First Close	Jul-07
Actis (global)	Actis Africa Real Estate Fund	Africa	150	Closed	Aug-06
Alfa Capital Partners	Marbleton Property Fund	Russia	320	Closed	
Apollo Real Estate Advisors	Sun Apollo India Real Estate Fund	India	630	Closed	Dec-06
Arch Capital Management	ARCH Asia Property Fund	Asia	200	Raising	
Atlas Investment Group	Saraya Real Estate MENA	MENA	250	Closed	Sep-06
Carlyle	Carlyle Asia Real Estate Partners	Asia	410	Closed	Aug-05
Castle Rock Capital Management	Castle Rock IREGO II	India	150	Raising	
Citigroup Property Investors	CPI Capital Partners Asia	Asia	1,291	Closed	Feb-07
Colony Capital	Yangtze Special Situations Fund L.P.	Asia	92	Closed	Jun-05
Duke Equity Partners	DukeIndia Real Estate	India	300	Closed	Sep-06
Emerging Markets Advisory Corporation	Illyrian Land Fund II	SE Europe	100	Raising	
Equity International	Equity International III	Global	300	Closed	Jan-07
Europa Capital	Europa Emerging Europe	C&E Europe	200	First Close	
Forum Partners	Forum Asian Realty Income II	Asia	600	Closed	Jun-07
GED	GED Real Estate Eastern Investments	SE Europe	208 (150 EUR)	Raising	
Global Finance	Global Emerging Property Fund	Balkans; Bulgaria; Romania; Serbia	160	Closed	Jun-05
HDFC Property Ventures	HDFC International Real Estate Fund	India	800	Closed	Aug-07
Heitman Real Estate Investment Management	Heitman Russia and Ukraine Property Partners	Russia/Ukraine	150	Raising	
Hines Investments	HCM Holdings II	Mexico	100	Closed	Mar-07
IL&FS	IL&FS Infrastructure and Real Estate Fund	India	900	Raising	
Indochina Capital	Indochina Land Holdings II	Vietnam	265	Closed	Aug-06
ING Real Estate Investment Management	ING Real Estate China	China	350	Closed	Dec-06
ING Real Estate Investment Management	ING Real Estate China	China	350	Closed	Jun-06
ING Real Estate Investment Management	ING Real Estate Asia Value Added Fund	Asia		Raising	
JM Financial Investment Managers	Infinite Investment Management	India	400	Raising	
LaSalle Investment Management	LaSalle Asia Opportunity Fund II	Asia	4000	Closed	Jul-05
Morgan Stanley Real Estate	Morgan Stanley Real Estate Fund VI Intl	Global	8,000	Closed	Jun-07
Paladin Realty Income Properties, Inc.	Global housing fund	Pan Emerging Markets	200	Raising	
Pegasus Capital	Pegasus Real Estate Fund	Latin America	210	Closed	Jun-07
ProLogis	ProLogis MX Industrial Fund LP	Mexico	625	Closed	Aug-07
RealCAPITA	Injaz AsiaEquity Property Fund	Asia	100	Closed	Jun-07
Red Fort Capital	Red Fort Capital	Global	150	Closed	Nov-06
RREEF	Real Estate Opportunities Fund II	Global (incl emerging Asia emphasis)	1600	Closed	Oct-06
TransGlobal Financial	TransGlobal Turkish Realty Fund	Turkey	125	Closed	Jun-07
TCG Real Estate	India Property Fund	India	400 target; 100 first	First Close	May-07
VinaCapital	VinaLand Real Estate Fund	Vietnam	205	Closed	Mar-06
Warburg Pincus	Warburg Pincus Real Estate Fund I	Global	1,200	Closed	Oct-06
Welbilt Realty Partners	China New York Real Estate Opportunity	China	200	Raising	

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Other firms are moving to new target sectors within countries where they have already been investing. For example, **Prologis**, a leading industrial real estate firm, began investing in Mexico in 1997, developing facilities along the northern border focused on export manufacturing to the United States. Since then, "The Mexican economy has matured and grown," said vice president Arthur Hodges, and the opportunity has shifted to meeting "the need for domestic distribution for the growing consumer market." Prologis recently acquired 3.5 million square feet of industrial space and land near Mexico City and other consumer hubs for US\$238 million.

Morgan Stanley's Sonny Kalsi noted that his firm in general is targeting middle class residential and mass retail oriented investments in emerging markets, but he expects that as the countries develop, opportunities will increase at the higher end in office space and luxury apartments.

### Some Risks and Concerns

Asked about the challenges to investing in private equity real estate in emerging markets, industry leaders emphasized regulatory risks and the concern that there may be overinvestment in some sectors. Dave Hardman of Warburg Pincus said, "We feel comfortable that demand for real estate in emerging markets is sustainable, but we've seen through experience that you need to have an extra cushion to deal with the unexpected. Probably the biggest challenge is when regulations are changed or inconsistently applied."

One of the most important regulatory-related challenges remains acquiring clear title to assets. Frequently what distinguishes the local development firms that private equity real estate firms are investing in is the skills and relationships needed to build a landbank of properties with clear title. "There's more art than science to the process of building a landbank," said Kalsi. "Firms that are good at it can build a brand name that municipalities and other key players like working with and will go back to in the future."

Another challenge is overinvestment. Garrabrant of Equity International commented that "an extraordinary number" of funds have been organized to invest in land in India, creating "tremendous land inflation." "What the country needs is infrastructure," he said, "Not overpriced land."

Kalsi said while Morgan Stanley is "bullish" on the consumer-oriented opportunity in Asia, there are some sectors the firm is avoiding, such as high-end residential developments and high-end hotels in second and third tier cities in China. "There are only so many million dollar apartments you can sell outside of Beijing and Shanghai," he said.

### Overlapping Categories

Many "generalist" private equity firms in emerging markets are also seeing the opportunities in real estate and making investments in the sector. **H&Q Asia** announced in late 2006 a US\$550m partnership with RREEF and Hilton Hotels to develop 25 hotels in China. The Asia-focused firm **Lombard Investments** has made several "private equity real estate like" investments in recent years, including investments in a mall developer, home builder, and factory-for-rent provider in Thailand.

In general there is not a great difference between an investment in a real estate related company made by a private equity firm as compared to a private equity real estate firm. The key difference is in the skill sets the investors have to draw upon, with Private equity real estate firms obviously bringing more real estate related experience, while private equity firms bring more company building experience.

A pattern that is emerging is for a private equity firm to experience success with initial real estate investments from a generalist private equity fund and then to expand that business into a specialized offering for LPs. According to Dave Hardman, Warburg Pincus launched the global real estate fund following a "very successful" investment from the firm's global private equity fund in Europe and in emerging markets real estate opportunities. Likewise, private equity firm **Actis** has gone from initial forays in this domain to raising dedicated private equity real estate funds focused on India and Africa.

As Hardman of Warburg Pincus noted, "Many LPs don't expect to see more than a few real estate investments in the portfolios of their private equity managers. We saw an opportunity to scale these investments beyond that level, and that led naturally to a dedicated fund."

The reverse process is happening at the real estate private equity firm **JER Partners** which is leveraging its increased exposure to emerging markets real estate in Russia and Latin America to launch a new emerging markets private equity fund of funds product.

Firms moving into private equity real estate should find a robust appetite among LPs. The expanding pool of established institutional capital in the US and Europe has a healthy allocation to direct real estate, according to a recent RREEF<sup>4</sup> report, which shows US pensions on average allocating 7% of resources to the sector. The report also indicated that on average European pension funds are far below target allocations, suggesting an increase in future commitments. Investment from the Middle East focused on real estate in Asia is also increasing rapidly.

With substantial market growth ahead and increasing sources for capital, the prospects are good for private equity real estate in emerging markets.

<sup>4</sup> "Real Estate Industry: An Overview" published by RREEF.