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Real Estate

Newer firms taking a fresh approach to recapitalization

By Arleen Jacobius

Recapitalizations are no longer a way for veteran real estate managers to move the odds and ends left over in their funds into new sidecar funds. Now, newer managers are increasingly spinning off majority stakes in their portfolios or individual properties to a growing number of secondary market managers.

Such deals can be a lifeline for newer managers, providing them with a big exit and an instant track record to use to raise a new fund. This option is especially welcomed by emerging real estate managers struggling to raise capital from asset owners that prefer to invest with managers they already know.

OUTSIDE FORCES: Sarah Schwarzschild cited the pandemic as a catalyst for the investment shift.

In the history of alternative investment secondary markets, there have been catalysts — such as the global financial crisis — that spurred the growth of these markets, said Sarah Schwarzschild, New York-based managing director and co-head of BGO Strategic Capital Partners, BentallGreenOak's secondary real estate market business.

The pandemic increased some managers' need for liquidity, she said. The ensuing uncertainty surrounding valuations also extended the time managers are holding properties, which means the funds that own those properties may be running out of capital, requiring an infusion of fresh funds to continue owning them, she said.

The financial crisis, for example, resulted in investors using limited partnership interest sales for portfolio management and for liquidity, Ms. Schwarzschild said.

The COVID-19 crisis will emerge as a atalyst in real estate, for GP-led transactions rather than for LP stakes, she said. GP-led transactions aren't new, but until now, most of them involved recapitalizations of so-called tail-end funds, those at the end of their lives that held a few assets that needed to be sold, she explained.

"What we saw emerging in the past year or so was not just recapitalizations of funds but individual assets or pools of assets" as well as more structured transactions than in the past, Ms. Schwarzschild said. Joint ventures are also being recapitalized, she said.

"You can recapitalize anything. Recapitalization means inserting new capital into a structure," Ms. Schwarzschild said.

In a recapitalization, the manager moves an entire portfolio or a selection of properties to a new fund, a joint venture or other vehicle in which the investors are a secondary market manager or a secondary market manager and limited partners.

Institutional partner

Emerging real estate mangers with "meaningful portfolios" also get the benefit of working with a more institutional partner such as a secondary market manager, rather than high-net-worth investors, said Robert Kohn, New York-backed partner at Park Madison Partners LLC, a placement agent that is also arranging these recapitalizations. "Interest in recaps (recapitalizations) is at an all-time high," Mr. Kohn said.

More real estate managers — veteran and emerging — are turning to recapitalizations as a way to hold onto parts of their portfolios for longer than their fund lives would otherwise allow, he said.

"Increasingly managers and investors are understanding high-quality portfolios are difficult to assemble or access, difficult to replace, and continue to gain value over periods longer than three to five years," Mr. Kohn said.

In 2020, alternative investment managers across asset classes accounted for 27.3% of all secondary market sellers, as they looked to raise money to support their portfolios or to create liquidity for their LPs, according the most recent volume report by secondary market broker Setter Capital Setter Capital.

Indeed, GP-led recapitalizations were up by 10.8% to $32.4 billion in 2020, while traditional secondary deals involving sales of alternative investment fund interests fell by 47.7% to $29.36 billion from the prior 12-month period.

There were $1.04 billion in real estate GP-led recapitalizations in 2020, from $1.29 billion in 2019.

"Our fund manager solutions team have predicted larger GP-led transactions in 2021 as they have recently seen an increase in GP-led transactions due to the delay the pandemic has caused on GPs' exit plans and stronger buyer appetite for GP-led transactions from secondary investors," said Cecilia Banares, Setter administrative director, in an email.

Newer real estate managers are increasingly embracing GP-led recapitalizations to speed up liquidity for LPs, in some cases so these LPs can commit to the GP's new fund, said Larry Abraham-Ajayi, vice president and head of Setter's fund manager solutions team. Recapitalizations also preserve the manager's assets under management because the GP continues to manage the properties in these GP-led deals and recapitalizations help to expand their investor base, Mr. Abraham-Ajayi said.

More transparency

At the same time, the recapitalization market has matured with increased liquidity and transparency, he said.

"The perception of discounts associated with recapitalizations is no longer accurate for high quality assets that are managed well," Mr. Kohn said.

In many GP-led recapitalizations, LPs have the choice of exiting their investment in the fund or rolling that investment into a new fund, joint venture or other vehicle. Typically, a secondary market manager buys the properties or portfolio and becomes an LP in the new fund or joint venture, he said.

Increasingly, in addition to recapitalizing assets in the old fund, investors can choose to commit fresh capital with the manager, either in another new fund the GP is raising at the same time as the GP is recapitalizing assets in the old fund or in the form of co-investments, Mr. Kohn said.

Recapitalizations are the latest evolution of the GP-led transactions, which is a small but growing portion of the real estate secondary market. New managers are also looking to GP-led transactions to reduce their funds' investments in certain property types or regions, which may be over their funds' concentration limits, BGO Strategic Capital Partners' Ms. Schwarzchild said. This can occur with asset types that are selling at a premium such as industrial properties, causing the fund to exceed its maximum invested in warehouses, she said. In such a case, the manager can move assets into a sidecar vehicle with the secondary manager and sometimes also limited partners, solving the issue.

Recapitalizations also free up capital to buy more assets, she said. Both new managers and more mature managers are leading recapitalizations for this reason, she said. Managers like the strategy because the seller usually keeps a small interest in the portfolio and also is retained to continue managing the portfolio.

A recent example is Boston-based NorthBridge Partners, which sold off a majority interest in its second fund to Brookfield Asset Management in March.

The industrial portfolio, which had a gross asset value of $360 million, represented just a portion of NB Partners II, said Greg Lauze, managing partner, NorthBridge Partners in an email in response to questions.

The recapitalized portfolio was spun into a joint venture, in which Brookfield is the majority owner. NorthBridge executives bought the remaining minority interest in the recapitalized portfolio that had been in NP Partners II and continues to manage it, said Chris Reilly, New York-based managing partner who heads the secondary markets team at Brookfield.

"NorthBridge wanted to raise a third fund and they needed a liquidity event and to print the track record," give their investors an opportunity to cash out the investment or allow them to invest in the third fund, Mr. Reilly said.

On April 26, NorthBridge Partners and its placement agent, Park Madison Partners announced the final close of NB Partners III at its $500 million hard cap.

"We were able to get access to a good portfolio of industrial assets that still have upside and is pretty-well stabilized," he said.

Enhanced opportunity set

The COVID-19 pandemic enhanced the opportunity set even more, he said.

Earlier during the COVID-19 crisis, Mr. Reilly said his team saw more sales of limited partnership interests in commingled funds by investors that needed liquidity, he said. At this stage in the pandemic, Brookfield executives are seeing more deals along the lines of what NorthBridge did, he said.

"The GP's investors are high-net-worth individuals and the GP made a good return. The GP may be looking to raise a new fund or to transition from high net worth investors to having a larger, more institutional investor like a Brookfield," Mr. Reilly explained.

"That's a theme we're seeing on a regular basis: a small to midsized GP that's a good operator and wants to transition to a more institutional asset manager," he added.

Recapitalizations, which started as a private equity strategy, are in an early stage in real estate and an even earlier stage in infrastructure, Mr. Reilly said.

In private equity, general partners started off using recapitalizations to sell their worst and problem assets, he said. Now more managers are familiar with these deals and want to "recapitalize their crown jewels," Mr. Reilly explained, because it's hard to find good investments.