Skadden

Private Equity and Sovereign Wealth Interests Converge in US Real Estate

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This article is from Skadden's *2022 Insights*.

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Takeaways

- PE activity, both fundraising and investing, has exploded.
- Sovereign wealth and foreign government pension funds have grown in sophistication, built out in-house capabilities and become increasingly focused on real estate, and U.S. property is a particularly attractive asset class from a control, return, tax and diversification perspective.
- We are seeing increasing collaboration between these foreign investors and PE firms in the U.S. real estate market, and a trend toward co-investment and co-GP arrangements.
- As a result, U.S. real estate deal activity seems unlikely to abate anytime soon.

Private Equity and Real Estate

After a brief slowdown early in the COVID-19 pandemic, private equity (PE) deal activity rebounded in the second half of 2020, and that momentum built in 2021. By the middle of 2021, PE accounted for 30% of all M&A activity, PE deal volume was at its highest level since 2006-07 and there were more $10 billion-plus buyouts than in any year since 2007.

For the near-term, PE activity seems likely to continue to skyrocket. PE firms were estimated to have amassed $3.3 trillion in unspent capital, or "dry powder," by mid-2021, and fundraising continues to trend upward, with new funds launched in 2021 reportedly seeking to raise over $500 billion. Since fund terms often limit the time in which capital can be deployed, we expect to see the trillions of dollars invested in the short to medium term.

A sizeable portion of the dry powder is earmarked for real estate, which is viewed as a hedge against inflation. According to Bloomberg, PE funds had over $280 billion in committed capital for real estate deals at the end of 2021, an 11% increase from a year earlier and 57% more than at the end of 2019.

In recent years, the PE industry has devoted more attention to real estate as an alternative investment. Returns have been attractive, and the asset class is appealing to those investors seeking to deploy capital for long periods. This contrasts with corporate buyouts where investments often are realized in three or five years, leaving investors to find new places for their capital. Commercial, industrial, medical office and life-sciences real estate have remained favorite subsectors and, more recently, residential property (both single- and multi-family) has joined that mix.

Another driver of PE activity in the real estate industry is the general trend of consolidation and proliferation of large real estate portfolios, resulting in large complex trades.

Foreign Government-Linked Investors and Real Estate

While traditional investments such as equities and fixed income investments have historically formed a substantial part of the assets held by sovereign wealth funds and foreign government pension pools (together, sovereign equity), there has been a trend over the last 10 years toward alternative assets, including real estate. Sovereign equity investors typically have long investment horizons and large amounts of capital to deploy; as such, long-term investments in the real estate sector are not only attractive, but desirable.

The size, stability and sophistication of the U.S. real estate market has made it a natural place for sovereign equity to place funds for long periods of times. Sovereign equity investors have increased their allocations to U.S. real estate given its strong performance, according to the Sovereign Wealth Fund Institute.

Unlike a business, where a sovereign equity investor might be looking at minority board seats and they are dependent on management for crucial operational know-how, they can exert greater control over their real estate investments, including major decision rights and advisory board seats.

With increased rights, sovereign equity investors must consider potential regulatory hurdles that can arise as a result of greater control, including interest from the Committee on Foreign Investment in the United States (CFIUS or the committee). Although unlikely to trigger mandatory filings before CFIUS, real estate investments often fall within the national security regulator's voluntary jurisdiction. With an uptick in CFIUS' proactive outreach to investors regarding transactions not voluntarily notified to the committee, CFIUS implications should be considered early in the investment process.

The Intersection of PE and Sovereign Equity: US Real Estate

The goals and attributes of sovereign equity and PE firms create natural synergies between the two, particularly in real estate. PE firms seek large amounts of capital to invest, and sovereign equity investors control and deploy enormous sums of long-term capital. Sovereign equity seeks greater control over their investments, but does not necessarily want the burden of being a sole owner in a foreign market with little to no internalized day-to-day asset management capabilities and few local industry relationships.

Real estate is an area where, working with PE firms, sovereign equity can achieve enhanced returns and exert greater control over investments without having to build deep operational teams or deal with other issues created by direct investing. PE firms provide industry expertise, operational support and access to relationships, while sovereign equity can supply large amounts of capital that allow PE firms to move nimbly when opportunities arrive, without the pressure of deadlines to put fund capital to work.

Collaborating with PE managers can also mitigate other issues associated with direct investing by foreign entities, such as national security reviews. For these reasons, sovereign entities have most often operated in a largely passive role, investing as limited partners in funds.

However, as relationships between sovereign equity and PE firms develop, they sometimes become not just co-investors but also co-GPs, with sovereign equity taking stakes in the sponsors and asset managers with whom they invest, providing the foreign institutions increased upside and reduced fees. As co-GPs with third-party LPs, sovereign equity can share in carried interest and management fees. Not surprisingly, many sovereign equity institutions now have, or are developing, sophisticated in-house deal and legal teams that can underwrite and execute transactions.

As sovereign equity has become more sophisticated and further develops in-house talent, we will likely see them collaborate more with PE firms, especially in asset classes like real estate where both parties can readily achieve their goals.