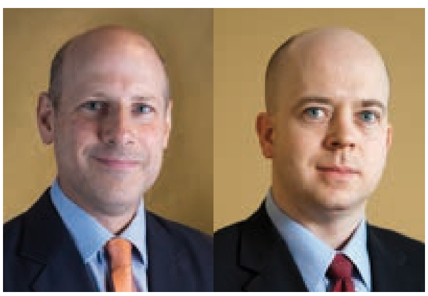
Chasing the pack

KKR was one of the later entrants to the real estate space, but it is aggressively seeking to catch up with its competitors, writes Evelyn Lee

In a 42nd-floor dining room overlooking Central Park, Ralph Rosenberg is talking about how he measures success.

"While many in our industry focus on AUM, that's not really the relative metric in my mind," KKR's global head of real estate says over a breakfast spread of yogurt, granola, fruit, eggs and baked goods at the global investment firm's midtown New York headquarters. "The real question is, how profitable are you and how good an investor are you for your fiduciary relationships with your limited partners?"

It has been more than six years since KKR hired the 25-year real estate veteran to head its new global real estate business. Since then, the platform has expanded to include 50 investment professionals in seven offices in the US, Europe and Asia. Five have joined Rosenberg for this interview: Chris Lee, co-head of real estate credit; Bryan Southergill, who leads the firm's Asian real estate strategy; Billy Butcher and Roger Morales, two of three co-heads of Americas commercial real estate acquisitions. Guillaume Cassou, head of European real estate, has dialed in from London.



Lang and Walker: TRS was one of the earliest investors in KKR's real estate business

To Rosenberg's point, the firm has already made multiple roundtrips on its real estate investments, which began in 2012. In May, for example, KKR agreed to sell Sentio Healthcare Properties to Kayne Anderson Real Estate Advisors for $825 million, after committing $150 million of convertible preferred equity to the company in 2013.

Notably, KKR has returned more than 70 percent of the capital in its first US real estate fund, KKR Real Estate Partners Americas, which attracted a total of $1.5 billion in 2013 and whose investment period ended earlier this year. Managers typically do not return capital until years five to 10 of a fund, if not longer, according to Stephen Ellis, director of financial services equity research at research house Morningstar. "Being able to return 70 percent of the capital in that short a timeframe is a good achievement," he says.

REPA generated a gross internal rate of return of 21.5 percent, a net IRR of 16.1 percent and a multiple of invested capital of 1.4x as of June 30, according to the firm's second-quarter earnings results. The firm did not disclose performance data for its first European real estate fund, KKR Real Estate Partners Europe, and REPA II, since those funds' investment periods were less than 24 months as of the end of the quarter.

Size matters

Whether Rosenberg believes it or not, size is still seen as a measurement of success in the industry. Further, with one of the youngest property businesses among listed private equity firms, KKR currently has one of the smallest platforms. Rosenberg notes that the business is often perceived to be smaller than it actually is, with analysts typically calculating KKR's real estate AUM to be the total of the two property funds that have closed: REPA, which raised $1.5 billion in 2013 and REPE, which amassed $739 million last year..

He adds, however, that those estimates fail to account for all of the firm's real estate investment vehicles, as well as the approximately $1 billion of balance sheet capital that KKR has invested in the asset class.

These include a listed commercial real estate debt platform, KKR Real Estate Finance Trust, which went public in April and has a market capitalization of about $1.1 billion; Drawbridge Realty Partners, a US core-plus office vehicle that focuses on single-tenant properties and has close to $400 million of capital; and a non-bank finance company in India that currently has amassed about $300 million of equity from investors such as Singapore's GIC Private and Townsend Group.

Additionally, the firm is nearing final closes for REPA II, for which it is understood to be targeting $1.5 billion-$2 billion and had raised $793 million as of June 30, according to the firm's second-quarter earnings results; and KKR Real Estate Credit Opportunities Partners, a fund targeting risk-retention-related lending opportunities, for which KKR has already amassed more than $500 million of a $1 billion equity goal. Rosenberg declined to comment on the fundraises.

All told, the firm currently has more than $4.5 billion of equity committed or invested in real estate and real estate credit in more than 60 transactions globally, including the $1 billion in KKR balance sheet capital.

Money where your mouth is

A key growth driver – and differentiator – of KKR's real estate platform has been the firm's balance sheet capital.

"We really led with our balance sheet and I think the key there versus our competitors is it allows for proof of concept," says Lee. "That's a very critical differentiator for us as a firm. We can go out and execute the strategy before we actually go out and bring in third-party capital … We have a track record and we have assets we can actually drop in." For example, KKR's real estate credit platform was seeded with $400 million in balance sheet capital. A year after the business started investing and making loans, the firm began collecting third-party capital, and has now raised $1.1 billion for the strategy from investors such as Makena Capital Management, Townsend Group and the Teacher Retirement System of Texas.

"I think it's really smart for a firm like KKR to use their balance sheet to start investing prior to raising their first fund," says Eric Lang, senior managing director of external private markets at TRS, which has backed all of KKR's real estate funds.

"This is basically the proverbial 'put your money where your mouth is.' That really helped give investors a look into what type of transactions the real estate team was doing."

Real estate represented 10 percent of KKR's total balance sheet investments as of June 30, according to the firm's earnings results. "It just shows that they do have a big commitment to this strategy and it's something that they're looking to grow," says Meghan Neenan, a senior director at Fitch Ratings' financial institutions group.

Indeed, compared with its peers, KKR allocates a significantly larger amount of balance sheet capital to its real estate funds, committing 16.3 percent of the capital in REPA

KKR

Headquarters: New York
Total assets: $148.5bn*
Total real estate assets: $4.5bn
Real estate leadership: Ralph Rosenberg, global head of real estate; Chris Lee and Matt Salem, co-heads of real estate credit; Billy Butcher, Roger Morales and Justin Pattner, co-heads of Americas commercial real estate acquisitions; Guillaume Cassou, head of European real estate; Bryan Southergill, managing director

**As of June 30*

Moving into real estate

1976	2011	2013	2013	2015	2017
Henry Kravis and George Roberts form KKR	Ralph Rosenberg is hired as global head of real estate	Final close of first real estate fund, KKR Real Estate Partners Americas	Launch of Asia real estate business with hire of Bryan Southergill	Launch of real estate credit business; hired Matt Salem as co-head of real estate credit	Initial public offering of KKR Real Estate Finance Trust

and 9.4 percent of the capital in REPE, according to its second-quarter earnings results. By contrast, many of its competitors typically make a 1-2 percent GP co-investment in their funds, according to Neenan.

Also powering the real estate platform has been the strong collaboration across all of KKR's businesses, which has appealed to investors like TRS. "We can talk to senior leadership of retail companies that KKR has relationships on the private equity side to help us get a view or insight on something that may be going on the real estate side," says Grant Walker, the pension system's senior director of real assets.

Playing catch up

Yet relative to its listed peers with real estate businesses, KKR falls somewhat under the radar, according to some analysts who track the firm. "If you talk about alternative managers, Blackstone is easy to talk about, Carlyle in the US is easy to talk about. They've done really well," says Neenan. "Beyond that, there's not really much to say."

Talking specifically about KKR, she adds: "I wouldn't be surprised if some people didn't know that KKR had a real estate platform. I think people think of Blackstone as being not just a private equity firm. In fact, private equity is one of their smaller segments. It's huge in real estate. I think people still think of KKR a lot as a private equity fund manager."

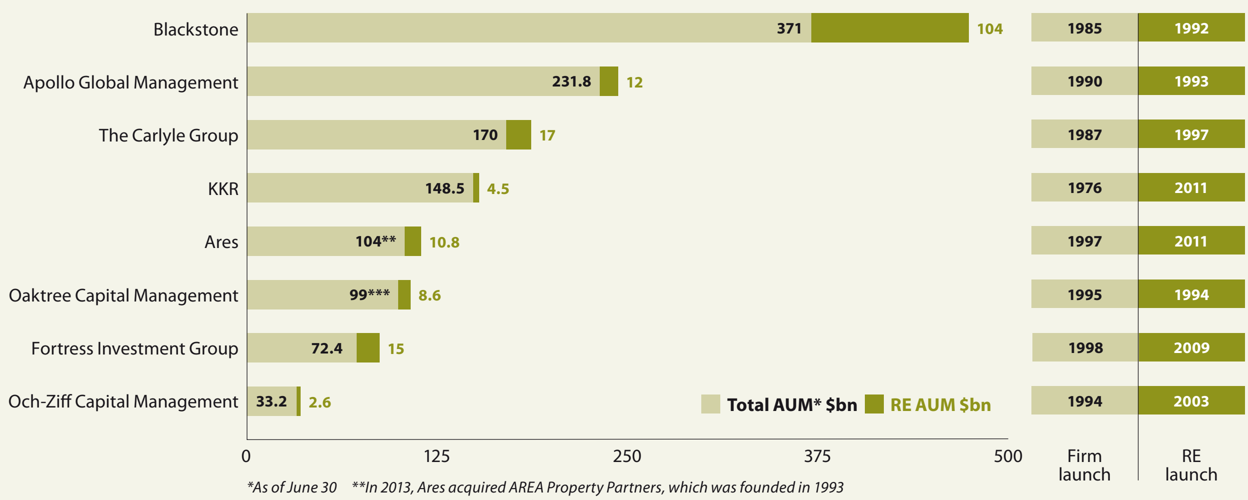
Founded in 1976, KKR did not launch step-out strategies – which include energy, infrastructure, credit and hedge funds – until the 2000s, with real estate not making its debut until after the firm's initial public offering in 2010. "KKR was late in general in exploring pretty much anything outside of PE," says Ellis.

Being a later entrant can be a disadvantage, especially when other firms already dominate the space. "That's the biggest challenge when you're a smaller fund: can you get the right type of dealflow?" Ellis notes. "If you don't get that first call, it's a bit trickier. You have to work a lot harder to make your returns."

Among eight private equity firms that have expanded into real estate, KKR's real estate business is the second-smallest by AUM and the smallest by percentage of total AUM, according to data from the companies. "KKR has got some catching up to do," says Ellis.

Stacking it up

Despite its long pedigree in private equity, KKR has been a latecomer to private equity real estate



*As of June 30 **In 2013, Ares acquired AREA Property Partners, which was founded in 1993
***Founders launched first RE fund prior to forming Oaktree

Sources: the firms

Binary bet

An unsuccessful foray into an oil price dependent property market taught the firm a valuable lesson about risk

Although KKR's real estate business has a successful track record, not all of its investments have gone according to plan. In 2012, the firm bought land to develop The Ridge at Harvest Hills, a project of up to 900 multifamily units and a similar number of single-family homes in Williston, North Dakota, in support of the oil production boom in the Bakken shale formation at the time. The thesis was that if crude oil prices remained at $100 a barrel, the firm would generate a mid-20s-percent unlevered IRR on its investment.

In the ensuing months, however, oil prices fell and have not recovered. KKR, which ultimately built 330 apartments and 36 for-rental single-family homes in project, took out 70 percent of its equity in the deal through a non-recourse financing and wrote down the remaining $15 million of equity three years ago. However, the loss was offset by profits generated from the firm increasing rental rates for its large multifamily portfolio as a result of the low prices.

"There are lessons learned," says Rosenberg. "Going forward, the bar is a lot higher to take risk where either you win or you lose. We like to make bets where there are lots of different ways to win and there are very few ways to lose."

Another takeaway is how the firm faces a problem and communicates the issue to investors. "Everybody can deal with success," he says. "It's how you deal with adversity that really differentiates you."

But size is not everything, asserts Lang at TRS, which formed a strategic partnership with KKR in 2011 and to date has committed $4 billion to the account. Of that amount, approximately 20-25 percent has been invested in real estate.

"We're big investors with Blackstone, and we have more invested in Blackstone real estate than we do with KKR real estate, but also we've invested with Blackstone real estate since 2006," Lang says. "They have been the most successful real estate platform of the public companies, but they also were successful before they went public. They were the market leader prior to them going public, as opposed to KKR building a business that's six, seven years old. I don't think you should just weigh size, as if bigger is better."

Both managers play important roles within TRS's real estate portfolio, Lang adds. "Blackstone has the ability to do very large scale transactions that sets them somewhat apart from some other firms. But there's also a need in the market for people to do typical size transactions as well, and that would be a KKR."

Moving the ball forward

Multiple industry observers say that KKR has taken a very measured approach to building its real estate business thus far. "Ralph is incredibly disciplined," says Brahm Cramer, head of commercial real estate at AllianceBernstein and a former colleague of Rosenberg's at Goldman. "At Goldman, we lived through a lot of volatility and ups and downs and failed deals, when you spend a lot of cycles working through that. He's been pretty diligent in taking those lessons learned to what he's doing at KKR."

TRS's Lang agrees. "They have sized their fund vehicles appropriately, even though we're in a time where people are awash in raising huge funds," he says.

At the same time, KKR has been "very, very aggressive" in building its real estate and other step-out strategies, including hiring new investment professionals, marketing new funds and developing relationships with new investors, says Ellis. "Some of the strategies, like real estate, are still fairly small compared to their peers, but they've been doing a lot of really great things to move the ball forward."

Ellis believes that KKR can eventually grow its real estate business to the $15 billion-$20 billion range in AUM, although it would be a tough target to achieve in the next five years. "I could see KKR getting the business to around $10 billion in five years," he says.

"We obviously have aspirations to continue to grow the business by strategy and by AUM," Rosenberg acknowledges, although he declined to discuss specific targets.

For example, KKR currently is making its Asian real estate investments through the firm's Asian private equity funds, balance sheet, separate accounts and special situations funds. That could change, however, as Scott Nuttall, co-president and co-chief operating officer, hinted in the firm's earnings call in July: "You'll see us expand into Asia, as well, with products over time."

There is also room for new real estate strategies, with the team reassessing its growth plan every year, Rosenberg says: "Looking at our five-year plan, it looks very different today than it did one year ago."

Adds Butcher: "In essence, the firm looks at AUM as the output, not the input. Looking at lessons of the past, those who have focused on investment performance and let AUM take care of itself have been the successful firms. To sit here and say we have a goal of this by this date, it's just not the way that works. But if we're disciplined, smart investors who play to our strengths and maintain that discipline, the business will naturally grow over time." □