New England Institutional RE Investor Forum

Valyrian Capital

June 2017

Round Table Session Details

Session: Round Table Discussion #9: The End of the Levered Beta Trade – Thematic Strategies in the Opportunistic Space

Thursday, June 22nd, 2017 at 11:35 AM

Moderator: Harry Almquist, Founder & Managing Partner

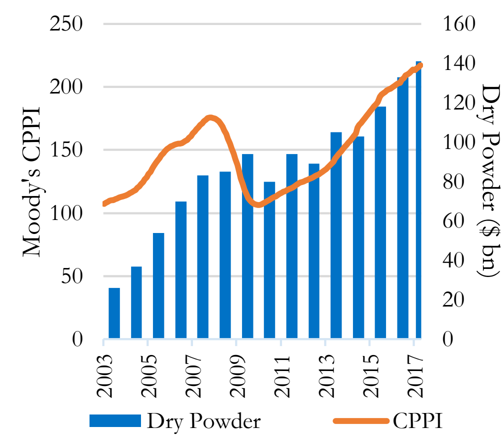
Summary Themes

- Commercial real estate levered beta trade is in its later innings and investors can no longer rely on broad based property appreciation to drive investment returns
- Going forward, investors will need to take a more strategic, opportunistic approach
- Transparency is also critical. Fund managers with broad, flexible mandates will need to ensure a high level of transparency to build and protect investor trust
- Traditional fund structures are ill-equipped for the current environment due to structural limitations, misaligned incentives and limited transparency
- Low yield environment and record amounts of dry powder allocated to real estate that is available to be put to work through co-investment opportunities

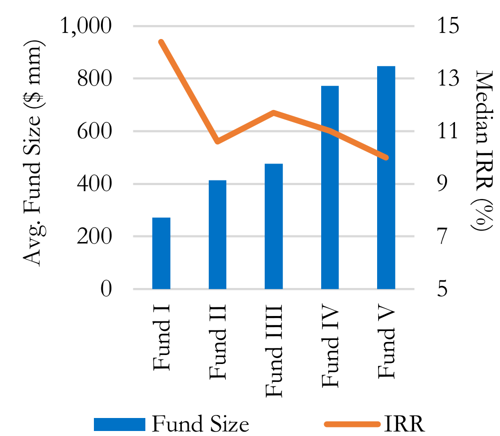
How We Got Here

- Commercial real estate has appreciated substantially following financial crisis lows, with national aggregate property values 23.3% above their pre-crisis highs
- Traditional real estate private equity firms (RE PE) have benefited from buying and holding real estate given low cost financing and strong property price appreciation ("levered beta trade"). Broad property appreciation, rather than operational improvements or opportunistic positioning, has driven returns
- The hunt for yield in the post QE environment & heavy inflows from foreign investors, who view US CRE as a safe haven, have extended the CRE cycle
- Levered beta returns and industry consolidation have insulated traditional RE PE firms from fee pressures, despite incentives that are misaligned with investors
  - **5 firms accounted for over 40%** of real estate fund raising in the previous year
  - Equity markets assign a **12-16x** multiple on management fees versus a **4-6x** multiple on performance fees, creating an incentive to accumulate assets
- However, the cycle is entering the later innings given property valuations, reduced credit availability and capital controls limiting foreign investors
  - Dodd-Frank risk retention rules have limited CMBS credit availability
  - High Volatility Commercial Real Estate (**HVCRE**) **BASEL III** capital requirements and regulatory scrutiny are limiting credit availability from banks
- Increased adoption of **demographic driven** strategies & **emerging institutional asset classes** (industrials, self-storage, student housing, senior housing), as investors look to get ahead of expected influx of institutional capital flows
- However, record amounts of dry powder remain to be deployed in an increasingly challenging environment for traditional real estate allocators and real estate investors constrained by traditional mandates in a historically unique investing environment

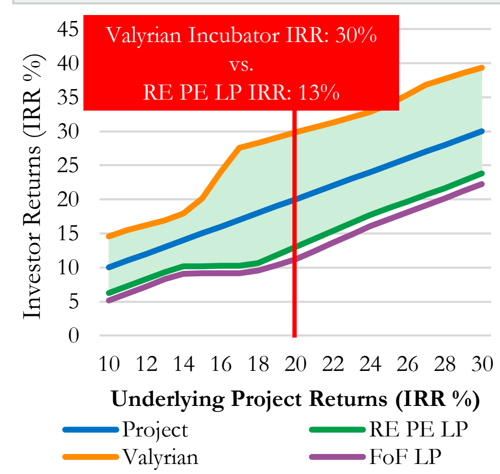
CRE Prices & Dry Powder at Highs



New Managers have Outperformed



Illustrative Valyrian Incubator Returns



Sources: Moody's, Preqin, Valyrian

Commercial Real Estate Debt Strategy

- Real estate debt has become increasingly attractive vs. equity given current state of the real estate cycle. Valyrian's debt strategies are not reliant on future price appreciation & are positioned to benefit from loan-to-own optionality at an attractive basis
- **Levered Senior Acquisition and Development Bridge Loans**
  - Banks are less willing to extend senior bridge or construction loans amid greater regulatory scrutiny and **BASEL III's HVCRE** regulations
  - Valyrian acts as GP, originating and structuring the senior loan and effectively quarterbacks the deal
    - The lower risk portion is syndicated to banks at low rates (generally 5-6%) and sized to meet their LTV limits & other u/w criteria
    - The remainder of the risk is syndicated to co-investors with Valyrian retaining the residual tranche to ensure proper alignment of incentives
  - Co-investment capital provides additional leverage and allows Valyrian to efficiently deploy capital across a more diversified portfolio, with Valyrian earning a promote or retaining excess spread over syndication rate – **effectively creating equity returns on senior debt risk**
- **Regulatory Capital Relief Pass-Through Participation Interests**
  - Banks have significant commercial real estate debt exposure on their books and are facing regulatory pressure to reduce risk
  - Valyrian would purchase a 49% pro rata pass-through participation, allowing the banks to de-risk, while providing Valyrian with active returns on seasoned senior debt that could be further enhanced with leverage or syndication to co-investors
- **Transitional Lending & Recapitalizations in Historically Overlooked Middle Market Space**
  - Traditional real estate private equity investors have significant amounts of capital that need to be put to work. These firms often have minimum required deal sizes, restrictive targeted return multiples, limited investment periods and can't (or won't) underwrite smaller deals
    - Provides Valyrian with an attractive opportunity to earn attractive risk adjusted returns providing capital to middle market borrowers who often have significant skin in the game
  - Valyrian has partnered with **Propellr**, a **real estate-focused technology enabled merchant banking platform**, and can leverage Propellr's technology to more efficiently underwrite and syndicate middle market loans vs. larger traditional real estate investors

Co-Investment Syndication Strategy

- Significant co-investment capital needs to be put to work and investors are in need of new ideas that offer attractive yields
- Valyrian has partnered with Propellr to create a unique syndication strategy that enables Valyrian to harness captive co-investment capital in order to provide leverage to a small, but opportunistic pool of GP capital
  - Valyrian will originate new investment opportunities under a broad mandate that offers superior risk-adjusted return profiles by focusing on opportunities created by the systemic misallocation of capital in traditional RE space & via creation of structural alpha Valyrian and Propellr will then syndicate these opportunities to high net worth individuals and family offices at a predetermined rate, with Valyrian and/or Propellr's captive investment manager, Aristone, retaining a portion
    - Co-investors benefit from radical **transparency** and consistent, detailed underwriting information that enables investors to create bespoke, customized & discretionary portfolios from curated opportunities across the RE risk spectrum
      - Co-investor economics are simplified, transparent and known upfront vs. traditional fund structures that rely on complex fee waterfalls
    - Offers access to a broader pool of co-investors vs. traditional RE PE funds where co-investors are drawn from a limited number of existing fund LPs who often must make co-investment decisions with limited information on short timelines
- Valyrian GP investors benefit from adaptive strategy & ability to efficiently deploy capital across a range of investments

Valyrian Fund Incubator Strategy

- In order to maintain maximum flexibility and ensure alignment of interests Valyrian would seed select funds pursuing unique strategies with intellectual and investment capital, in exchange for an equity stake or revenue sharing agreement entitling Valyrian's investors to a portion of the seeded manager's fee revenue
- First time investors have historically outperformed. Valyrian believes this is primarily due to better alignment of interests, with new fund managers largely dependent on performance fees given smaller asset base
- Valyrian is focusing on new managers who can capitalize on **structural and social inefficiencies**
  - Target borrowers who have traditionally been overlooked by rigid traditional private equity and bank lenders
  - Provide co-investment opportunities and capture assets under management from capital allocators with specific programs in place requiring greater deployment to MWOBs, emerging managers and other traditionally under-allocated investors
- Initial seed capital can be reduced and operational efficiencies improved by leveraging Valyrian's partnership with Propellr
- Facilitates creation of **fully disintermediated RE 'Fund of Fund' product** for Pensions & Endowments without added fee drag