

KKR

ALTERNATIVES
UNLOCKED

Unlocking Private Commercial Real Estate





Buildings shape people's lives. Whether they live in an apartment building, work in an office, order products online, shop at a retail center, or stay at a hotel on vacation, people around the world rely on commercial real estate every single day.

Being all around us, commercial real estate is a relatively simple asset class to define. But investing in commercial real estate requires more nuanced knowledge.

First Things First: What Is
Private Commercial Real Estate?



How Are Real Estate
Investments Structured?



Different Ways to Invest
in Commercial Real Estate







First Things First: What is Private Real Estate?

Private real estate refers to the many different kinds of properties, including commercial and certain types of residential, that are used for business or investment purposes generally with the goal of generating capital appreciation, income through rent, or both (Exhibit 1).

Private commercial real estate investments can be held directly (i.e., owning a building), or through an investment fund that does not trade on an exchange.

EXHIBIT 1 | Commercial Real Estate Sectors

 <h3>Residential</h3> <p>Examples:</p> <ul style="list-style-type: none">• Multifamily apartments• Single-family rentals• Student housing• Senior housing	 <h3>Industrial</h3> <p>Examples:</p> <ul style="list-style-type: none">• Warehouses• Manufacturing facilities• Distribution facilities	 <h3>Retail</h3> <p>Examples:</p> <ul style="list-style-type: none">• Malls• Grocery-anchored retail• Big-box stores
 <h3>Office</h3> <p>Examples:</p> <ul style="list-style-type: none">• High-rise• Suburban• Corporate campuses	 <h3>Hospitality</h3> <p>Examples:</p> <ul style="list-style-type: none">• Hotels• Conference and convention centers• Resorts	 <h3>Other</h3> <p>Asset types:</p> <ul style="list-style-type: none">• Self-storage• Data centers• Life science/lab space• Medical facilities

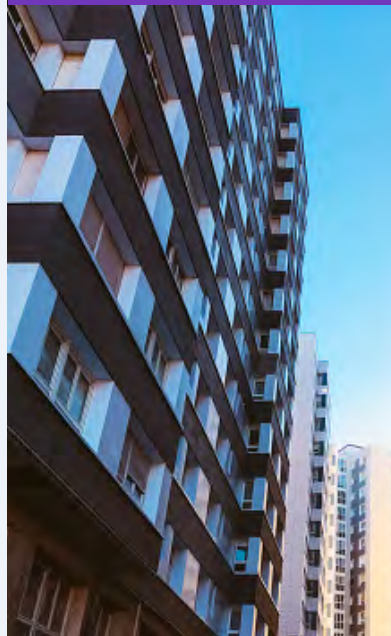
The ABCs of Commercial Real Estate Classification

Commercial real estate investors tend to classify properties into three different categories based on their level of quality (Exhibit 2).

EXHIBIT 2 | The 3 Classes of Commercial Real Estate Properties

Class A

- Highest quality
- Prime locations
- New construction/recently renovated
- State-of-the-art finishes and amenities



Class B

- Middle-quality: functional, usable space that may require some upgrades or renovations
- May be less well-located than Class A properties
- Generally older



Class C

- Lowest quality
- Older or outdated assets
- May not be operated or maintained well



How Are Real Estate Investments Structured?

In many ways, private real estate investments are just like an individual or family purchasing a home. Even the most complex real estate transactions can be broken down into two components: the debt, or mortgage capital, and the equity, or owners' capital. In large and complex private or commercial real estate transactions, there could be multiple lenders or multiple owners. Each is essentially a building block to get to all of the capital required for a commercial real estate transaction. This is called a capital stack, and it helps illustrate how different layers of both real estate equity and debt factor into the total value of a property.

EXHIBIT 3 | Home Mortgage vs. Commercial Real Estate Capital Stacks

$$\text{Down Payment (Equity)} + \text{Mortgage (Debt)} = \text{Gross Property Value}$$

How a Commercial Real Estate Capital Stock Compares to a Home Purchase Transaction



Home Purchase



Commercial Real Estate Capital Stack

Mortgage

Down Payment

Mortgage

Sponsor Equity*

*A sponsor is another term for ownership group.

The Differences between Equity and Debt

Real estate equity and debt function differently (Exhibit 4). Real estate equity, which represents ownership of a property, offers upside potential, but also downside risk. Debt (mortgages or other loans), can offer downside protection, but less upside potential.

EXHIBIT 4 | Real Estate Equity and Debt at a Glance

Real Estate Equity

Real Estate Debt

What is it?

Ownership interest in a real estate project or transaction

Lending to sponsors/developers to fund new purchases, new development, or refinancing

What do investors get?

- Income generated by the property (i.e., rent)
- Benefit from increases in value when property is sold (after debt is repaid)

- Periodic interest payments over the term of the loan and principal repayment at maturity
- Interest rates may be fixed or floating

What happens when property prices move up and down?

- Equity holders are impacted first by declines in property value or rental income
- If a property appreciates (increases in value), the equity value of the investment grows

Debt principal remains the same as property value changes

What happens if there are losses?

Equity holders are the first to absorb any losses

More protection from principal losses until equity value is zero.

Have first claim on income and sales proceeds if the borrower defaults, or fails to pay interest, principal, or both



Tracking a Property's Cash Flows



Property Cash Flows
(i.e.; rents, fees, proceeds from sales)



Sponsor

1

Interest and Principal Payments



Debtholders (Credit)

The proceeds go first to pay back debt holders.

2

Profits and Income



Shareholders (Equity)

After debtholders are paid in full, equityholders get the rest of the cash the building generates, in proportion to the size of their ownership stake.

How the Value of Equity and Debt Responds to Changing Market Environments

Underlying market conditions have a more immediate effect on the value of equity than on the value of debt. Demand for real estate in a particular area or sector, the economy, interest rates, and the features of the individual property can all affect a property's equity value. However, the debt principal does not change based on the property's underlying value* (Exhibit 5).

This means that debt holders have more certainty and downside protection, but less upside potential compared to equity holders.

EXHIBIT 4 | Real Estate Debt and Equity in Different Market Environments



*Structural Seniority is no guarantee against future losses or the receipt of interest and/or principal payments.

How to Access Commercial Real Estate Investments

Investors have many options for investing in commercial real estate (see Exhibit 6).

This ranges from direct investments in specific properties to investments in vehicles that own and manage diversified pools of real estate properties or loans.

Direct Investment

Investor(s) purchase an individual property for business use or investment.



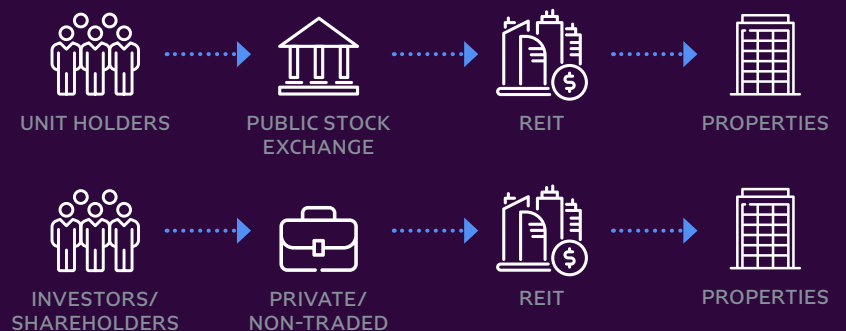
Private Placement

Groups of investors (Limited Partners) invest in a commingled vehicle, such as a Limited Partnership, managed by a real estate investment group (General Partner)



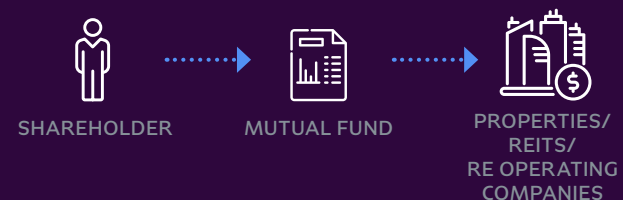
Real Estate Investment Trust

A company that owns, operates and/or finances income-producing real estate.



Mutual Fund

Pools money from many investors and invests in real estate operating companies and/or REITS.



Learn More

To find out more about real estate, please contact your financial professional. Financial professionals, please contact your KKR representative.

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