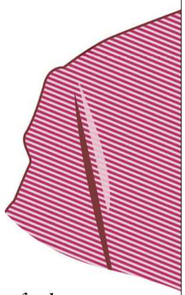
Analysis

How KKR reached scale through aggregation

The New York-based private equity giant has tripled its AUM in the past year without leaning on mega-deals.
By Kyle Campbell



A "16x growth opportunity" is how KKR viewed real estate in the spring of 2020.

Those words, emblazoned on a PowerPoint presentation given at a virtual conference, carried a dual meaning for the private equity titan. On one hand, there was the ambition to become a top-three player in private real estate. On the other was the stark reality of reaching that goal: "16x" referred to the difference between KKR's $10 billion exposure to the asset class and industry leader Blackstone's $160 billion.

During the presentation, Scott Nuttall, then the firm's co-president and co-chief operating officer, was not deterred by the disparity. In fact, the now-co-chief executive said the pandemic would be an "inflection point," for the fledgling platform. It has been.

KKR has nearly quadrupled its holdings in the sector since then, entering 2022 with more than $36 billion of real estate assets under management. It has also closed opportunistic funds on $2.2 billion, $1.73 billion and $4.3 billion in Europe, Asia-Pacific and the US, respectively, and launched a platform to raise retail capital that is nearing $2 billion of total value. It now operates 14 property type- and geography-specific platforms around the world.

With its eye on a top-three position in the industry, KKR is pursuing groups such as Blackstone, Brookfield and Starwood: dominant capital raisers that play globally, across real estate sectors and up and down the capital stack. But KKR has taken a different approach from private real estate's perennial powerhouses. Rather than use its considerable resources and brand to bulk up quickly through platform acquisitions, the firm has opted to grow virtually every one of its verticals internally and from the ground up.

For KKR, the key to reaching scale in real estate has been aggregation. "Every week, we're probably approving five to 10 acquisitions," KKR's head of real estate Ralph Rosenberg tells *PERE*, noting that most single-asset transactions are valued at less than $50 million, the byproduct of targeting niche assets in non-gateway cities. "Individually, they are smaller and less high profile, but we are playing the long game to build a diversified collection where the sum is greater than the parts."

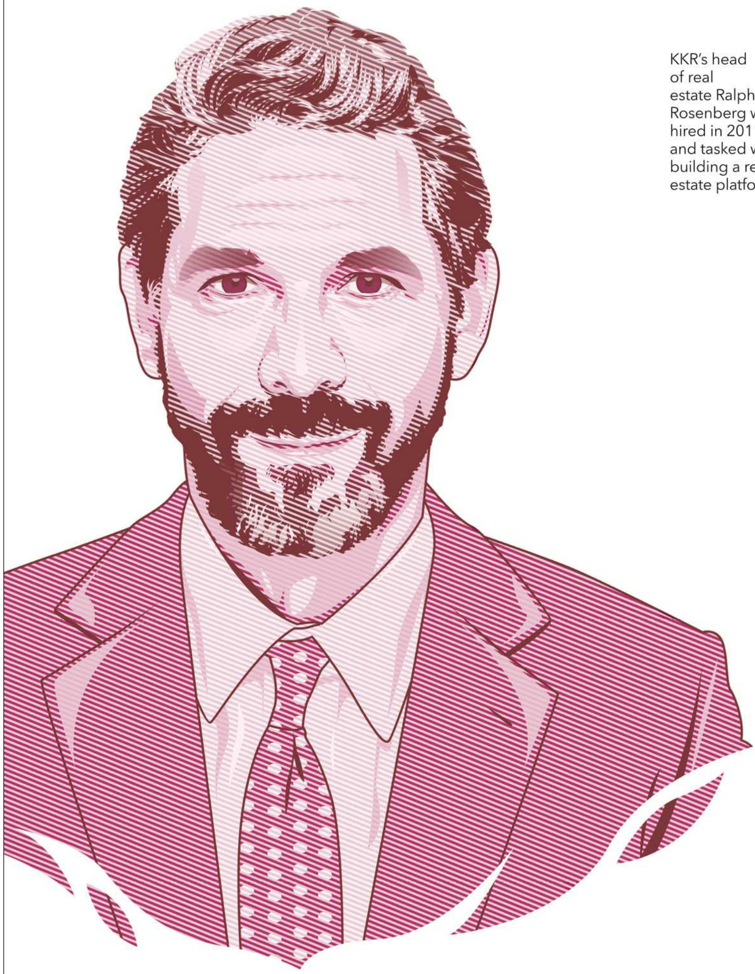
But the small deals add up over time, Rosenberg says: "It's a little bit like picking up pennies, nickels and quarters on the street. If you did that all day every day, all of a sudden, you'd wake up and you've collected a lot of money."

Ten years later

Rosenberg was hired by KKR in 2011 and tasked with building a real estate platform worthy of one of the biggest brands in corporate private equity.

A graduate of Brown and Stanford universities, Rosenberg started his career at Wall Street stalwart Goldman Sachs. His tenure at the investment bank included serving as co-COO of its Whitehall real estate fund series and Archon Capital Commercial Real Estate Lending Platform, before heading up its Special Situations Group. In 2006, he left Goldman to start a real estate-centric hedge fund, R6 Capital Management, which was acquired by now-defunct mega-firm Eaton Park Capital Management a year later. Rosenberg worked at Eaton Park until 2011.

When he joined KKR, the firm had virtually no exposure to real estate and was well behind peers such as Apollo Global Management, Ares Management, the Carlyle Group and TPG, all of which had been in real estate for



KKR's head of real estate Ralph Rosenberg was hired in 2011 and tasked with building a real estate platform

years, if not decades. With Rosenberg at the helm of the combined real estate credit and equity platform, KKR now has more real estate AUM than all but Apollo, which manages $41 billion.

His team has also achieved net internal rates of return of 25 percent, 11 percent and 10 percent for Real Estate Partners America II, Real Estate Partners Europe and Real Estate Partners America I respectively, according to KKR's third quarter 2021 disclosure.

Rosenberg is quick to praise the house for facilitating his success. He credits the firm's brand, its ability to encourage cross-platform collaboration through revenue sharing and its financial support – in the form of a $300 million proof-of-concept commitment in 2011 and an average fund participation of 10 percent – in getting the platform off the ground.

"We made some very good decisions structurally that have played to our benefit and some very, very good decisions commercially in terms of what we've done and what we've avoided that played to our benefit to allow us to get to this kind of scale," he says.

Rosenberg also acknowledges that other forces contributed to the rapid surge in KKR's real estate holdings. Last year, the firm finalized the acquisition of a majority stake in New York-based insurer Global Atlantic Financial Group. The transaction netted KKR what is effectively a "captive SMA" for investing in real estate debt, Rosenberg says. That accounts for nearly a third of KKR's real estate portfolio.

Similarly, the appreciation of certain property types and the demand for institutional real estate products during the pandemic era have been a rising tide that has lifted many boats.

"It's been an incredible market to raise capital in and to create commercial outcomes in," Rosenberg says. "If you look at the thematic, smart decisions that we made in terms of what to avoid and what to play in, given how much liquidity there is in the world, you can understand how we grew like this over this period."

Finding fragmentation

Another advantage KKR had coming into the pandemic era was a portfolio that included minimal retail, no hospitality and fewer than five gateway office buildings, Rosenberg says. This was largely the result of approaching the market with a "late-cycle" mentality.

"That meant staying away from highly cyclical asset classes, like retail and certain segments of hospitality, staying away from long dated business plans where you took a lot of construction risk and staying away from traditional office products that, when you don't believe in GDP growth, can be very expensive to asset manage and maintain," he said.

Because KKR was late to the fundraising trail coming out of the global financial crisis, launching its first fund in 2013, the firm was also priced out of some of the largest cities and biggest trophy asset classes. Instead, it sought opportunities where it would face less institutional competition.

This led to what Rosenberg describes as fragmented property types, such as student housing, senior

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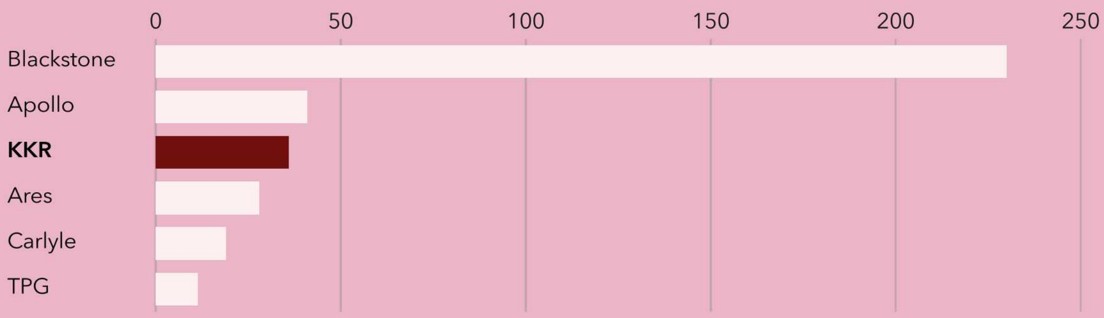
KKR Real Estate: Built from the ground up

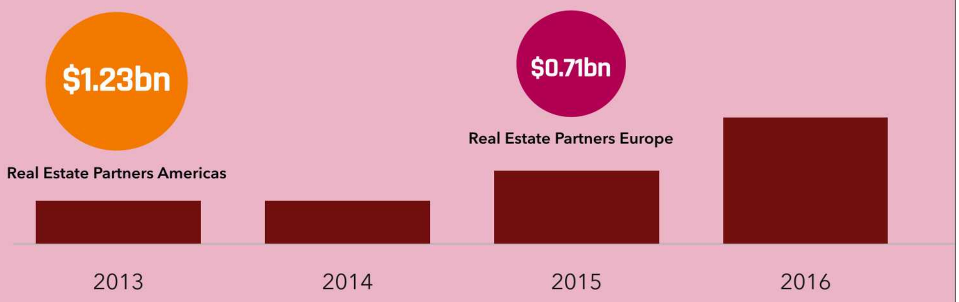
KKR platform org chart

Name	Region	Description
University Partners	US	Student housing
Alpha Industrial Properties	US	Industrial
KKR's hotel investment platform	US	Hospitality
Alpha Storage Properties	US	Self storage
My Community Homes	US	SFR
Strategic Lease Partners	US	Net lease
Sentio	US	Senior housing
CyrusOne	US	Data center
Activate	Europe	Irish residential
Ilovit/Newton	Europe	French office
Mirastar	Europe	European industrial
Etche	Europe	French industrial
Velero	Europe	German multifamily
China Logistics	APAC	Chinese industrial

KKR is passing PE rivals in real estate AUM, despite being late to the asset class ($bn)

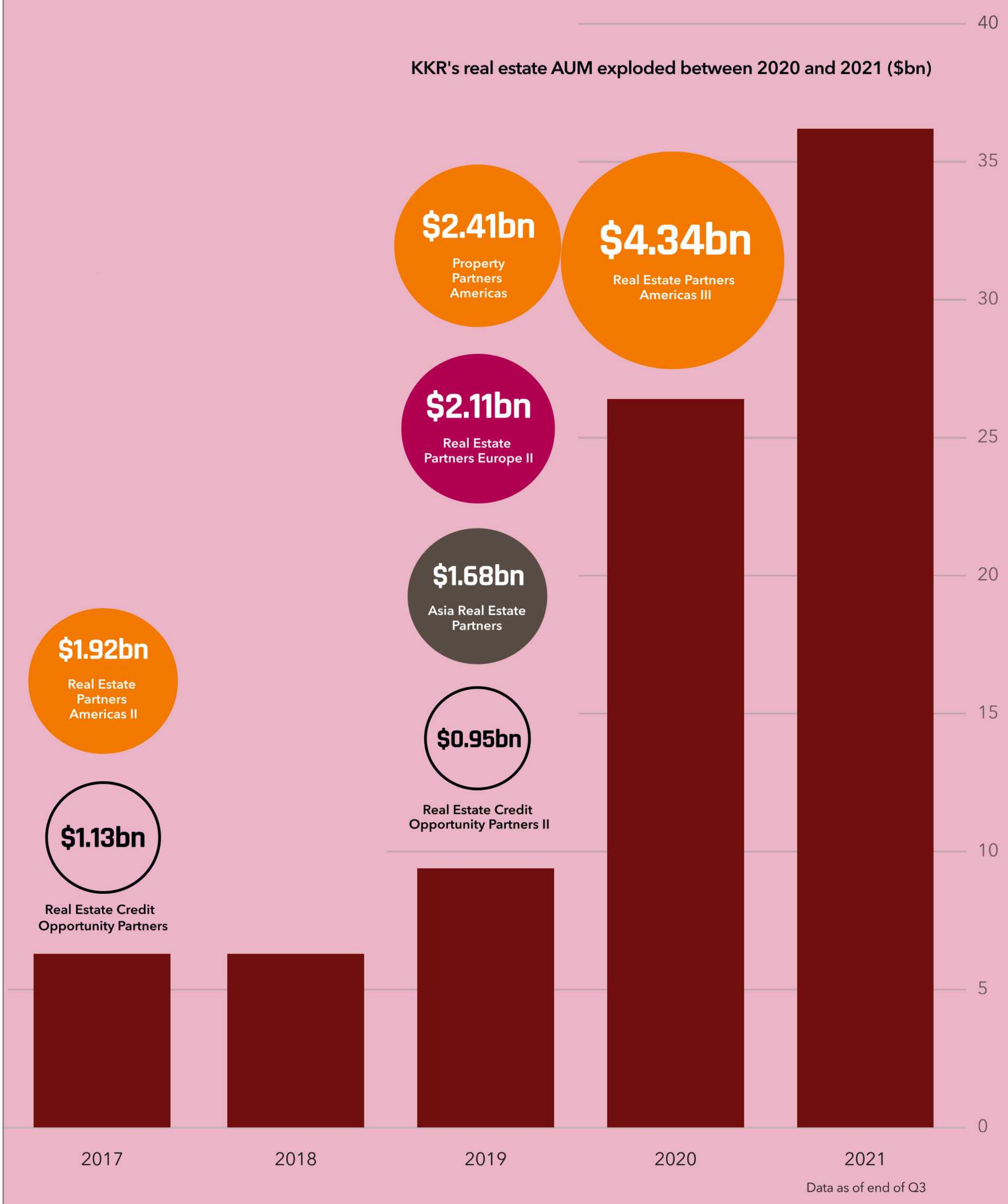


Fundraising efforts pick up steam across all regions between 2013 and 2021



Source: KKR Q3 fundraising report, investor reports and company disclosures

KKR's real estate AUM exploded between 2020 and 2021 ($bn)



housing, traditional multifamily, industrial and, more recently, self-storage and single-family rentals.

The firm created platforms for these and other property types, typically hiring a specialist from each category to run them. Their task is to roll up assets owned by individuals, families and small companies into portfolios.

Last year, the firm had its first exit from one of these strategies. It sold 149 US distribution warehouses to Oxford Properties for $2.2 billion. The portfolio was aggregated by Alpha Industrial Properties, KKR's US warehouse arm.

"That was a constructive example of the road map of what we're doing with fragmented asset classes," Rosenberg says. "It was 149 buildings purchased in over 50 individual transactions, aggregated over a 24-month period. We created a lot of value through leasing and marking to market in strategic logistic markets, and built an institutional quality core portfolio in terms of occupancy and tenant diversity."

With its oldest platforms dating back only to 2018, Rosenberg says the firm's portfolios are just now maturing to the point where exits are viable. "It takes a fair amount of time to get the scale we want, but you'll see more [portfolio sales] from us in 2022 and in the future."

Meeting demand

A central component to KKR's aggregation thesis is that because institutional investors are broadly under allocated to real estate, they are looking for ways to grow their portfolios quickly. According to the annual investor intentions survey by associations INREV, ANREV and PREA, published last month, the average current allocation to real estate among institutional investors was 8.9 percent, 120 basis points off the average target. As they look to bridge that gap, they will focus on the property types that have fared best through the pandemic, says Rosenberg.

"Large institutions are under allocated to these segments of the real estate market, so they're willing to pay a premium to get exposure," he says.

Ben Maslan, managing director at consultancy RCLCO, says there is an acute demand among institutional investors for ready-made pools of strong-performing assets. This is leading to recapitalizations and fund extensions on one end, and a competition for portfolios on the other.

While it has long been common to see premiums paid for portfolios of specialized properties, Maslan says it is noteworthy that such prices are being paid for multifamily and industrial, too. "The four major property types almost never receive a portfolio premium," he says. "You're still not getting a portfolio premium for retail or office portfolios. But because there's such a demand for residential and logistics, that portfolio premium has expanded over the past year and a half."

Oxford, for its part, was looking to establish an infill and light industrial portfolio to complement its larger footprint distribution platform IDI Logistics, Ankit Bhatt, vice-president of investments at the Canadian pension investor, tells *PERE*.

Bhatt says the collection of assets is "almost irreplaceable," because of the time and effort that would be required for it to build such a portfolio internally. "That's why these portfolios of scale see a tremendous amount of demand," he says. "We knew that this would be a great launching pad for our national light industrial business."

Skin in the game: How KKR wields its large balance sheet

KKR is not shy about eating its own cooking. If anything, it is first in line to get seconds

Not counting co-investment sidecars and other vehicles, the firm has contributed $1.7 billion to its real estate funds since 2013, according to its Q3 2021 earnings report.

Despite its track record in private equity, many investors and their consultants were hesitant to sign off on KKR as a first-time real estate fund manager, head of real estate Ralph Rosenberg tells *PERE*. A significant general partner commitment went a long way to assuaging those fears. It committed $200 million to KKR Real Estate Partners Americas, paving the way to a $1.2 billion final close.

"We have a very big and liquid balance sheet that we leverage to seed our new real estate strategies to show proof of concept and that we're willing to put our money where our mouth is with respect to creating commercial outcomes," Rosenberg says. "More importantly, it shows alignment of interest with our LPs in terms of our willingness to commit very large sums of money to launch these strategies and continue investing behind them."

The firm accounted for 10 percent of 2015's Real Estate Partners Europe, which closed on $713 million, 15 percent of 2019's Asia Real Estate Partners, leading to a $1.7 billion close, and it has continued to be a large contributor to subsequent funds.

Behind these activities is a large corporate cash reserve, Rosenberg says: "It is a very big differentiator for us even against the big players, let alone against the standalone managers."

All for one, one for all: KKR's approach to compensation

From his perch as KKR's head of real estate, Ralph Rosenberg manages 135 employees spanning a dozen offices in nine countries

Yet, he does not own a piece of his funds. No one at the firm does. Not directly anyway. As part of KKR's one-firm approach, all employees have an equity stake in the company and are paid from a single compensation pool. Revenue is divvied up to the business units based on their performance, but dispersal is decided by group leaders.

"We have the flexibility to take the comp pool and to distribute it across the team to reward commercial outcomes, collaboration, connectivity, leadership, management and cultural buy-in," Rosenberg says.

This model incentivizes collaboration within the real estate teams, and between different parts of the business, he adds. Because they are all tied to the same profit and loss statement, they have a vested interest in ensuring all parts of the business are running optimally.

"We're all aligned in terms of creating great commercial outcomes for LPs, which means great commercial outcomes for the firm," Rosenberg says. "If you do that, the business will continue to grow because people will trust you with more stewardship of their capital."

This model is radically different from most other private equity platforms, in which senior executives and fund managers are accustomed to owning a piece of their funds and benefiting from a specific share of their carried interests. But Rosenberg says it has not been a hindrance to attracting talent.

"People opt into this culture. When they interview at KKR, it's not a surprise," he says. "There is a type of person who prefers this model to a more formulaic model."

Balancing act

The aggregation model was once the industry hallmark for private real estate's top managers, and it remains the main avenue for success amongst emerging managers and even middle-market sharpshooters.

For the largest firms, which are raising ever bigger opportunity funds, the prospect of evaluating enough sub-$50 million deals to deploy a multibillion-dollar vehicle is untenable, Josh Herrenkohl, senior managing director at FTI Consulting, tells *PERE*. "Smaller players tend to be more focused on individual assets. But as you look at larger groups, especially those who raise these mega-funds, the only way for them to grow is through platform investments and mega-deals," he says.

KKR is attempting to do both, by raising multi-billion-dollar funds and investing globally – through three region-specific opportunistic series – while also being on the ground in markets, scouring for hidden gems.

Yet, the firm's recent expansion into real estate has not been devoid of mega-scale purchases. In November 2021, KKR tapped its real estate and infrastructure funds to partner with Global Infrastructure Partners on the $15 billion privatization of Dallas-based data center REIT CyrusOne. Dafina Dunmore, a senior director at the ratings agency Fitch, who tracks KKR, believes this is a sign of things to come as the weight of its funds pushes the manager toward bigger transactions.

"They're making larger investments because they have a lot more dry powder to put to work," Dunmore says. "From that standpoint, I would expect larger investments across the board; real estate, private equity and other asset classes as well, just given the sheer scale of the platform and the amount of dry powder that they have."

Rosenberg says CyrusOne represents a rare exception to its build-over-buy approach to platform procurement. Because of the high barriers to entry for the data center sector, both in terms of the assets themselves and the relationships necessary to lease them, building from scratch would not have been advantageous.

He notes that aggregation will continue to drive growth going forward. But he said large deals, like the CyrusOne privatization, will be in the mix moving forward, too. "We're creating a mouse trap to buy a $15 million self-storage asset in Dallas, all the way up to a $15 billion global data center platform like CyrusOne," he says. "We think having the ability to be able to play across that entire spectrum differentiates us."

Smart outcomes

For all its growth during the past year, KKR still has a long way to go to catch Blackstone. The industry leader's real estate AUM has since swelled to $230 billion, meaning it still has a 6x advantage over its crosstown rival. Rosenberg is not fretting over the figures.

"I'm a believer that if you do smart things, you're a good fiduciary, a good steward of capital and you make good relative value risk decisions, your business will continue to scale because people want to follow you and partner with you," he says. "I'll leave it to the people I work for to tell the market what their expectations are in terms of the future growth of business. I'm just trying to create smart outcomes." ■