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Real Estate Secondaries | Market Reflections

Asset Recaps – Here to Stay

August 2024

Setting the Stage

Investment trends—like fashion styles—can be fleeting, but under the right circumstances they can transition from a short-lived movement to a permanent staple (e.g., blue jeans for some). Over the past decade, real estate secondaries have evolved from a burgeoning opportunity set to a cycle-tested investment strategy. Initially, the real estate secondary market was dominated by traditional LP secondaries, or fund stake acquisitions. However, as the real estate secondaries market has matured, an arguably more attractive approach to secondary investing has emerged: direct secondaries, or GP-leds, including the recapitalization of individual assets or portfolios. Direct secondaries flourished during the latest series of dislocations, starting with the pandemic and accelerating as consequences of the rate hiking cycle continue to unfold. Liquidity needs and financing stresses prompted by a higher interest rate environment have created challenges across regions and property types. We believe that these market conditions have and will continue to create the most attractive opportunities within direct secondaries as sponsors seek secondary capital.

Direct secondaries – a permanent strategy

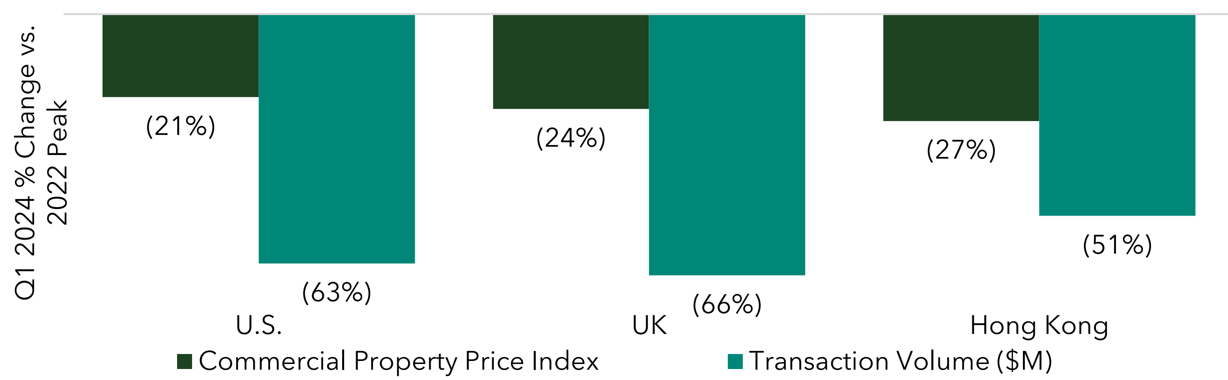
In the direct secondary format, we anticipate an enhanced ability to be highly selective over sector, asset and sponsor exposure. Investors should have the ability to construct portfolios targeting the most desirable sectors, while avoiding those that may be out of favor. Assets can be selected out of larger portfolios where the real estate fundamentals and pricing make the most sense. Limited capital availability should generate opportunities to work with sponsors that are best-in-class, including those that specialize within markets and/or sector verticals. Relatedly, we anticipate an increased ability to achieve better terms across economics, alignment and control with sponsors.

Capital constraints are expected to be the guiding principle behind direct secondary capital needs within the new real estate cycle that is underway. We anticipate the direct secondary opportunity set to grow as current market conditions persist and sponsor adoption of the real estate secondary market continues—solidifying a permanent role in the private real estate ecosystem.

Global Market Illiquidity

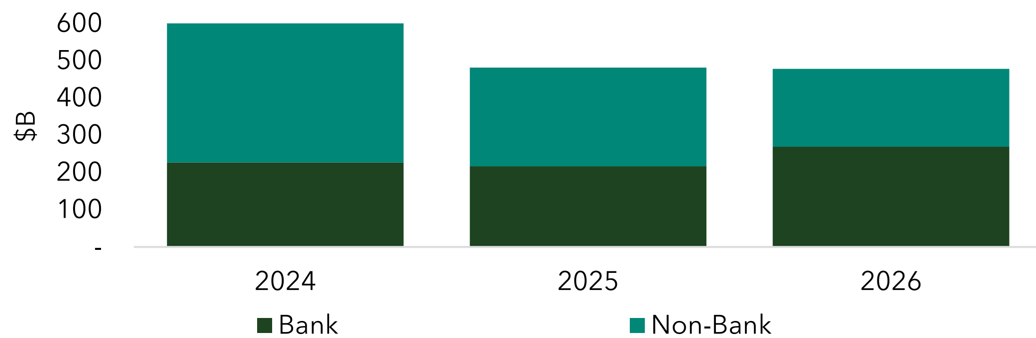
The high interest rate environment coupled with uncertainty surrounding the trajectory and magnitude of interest rate movement in 2024 have contributed to transaction volumes decreasing meaningfully from peak levels in 2022. Multifamily sales volumes are down 60% in the U.S. in 2023 vs the prior year.[1] Industrial transactions have declined 51% in Europe.[2]

Change in Commercial Property Price Index and Transaction Volume from 2022 Peak[3]



Refinancing is a topic on every borrower's mind today globally. In the U.S., nearly $600 billion of commercial real estate debt is projected to mature in 2024. Another $900+ billion is coming due in 2025 and 2026.

U.S. Commercial Real Estate Loan Maturities[4]



1 Globe St. as of February 2024: Multifamily Sales Slow So Far This Year but Experts Think That Will Change.

2 Savills as of March 2024: Take-up normalises across European industrial & logistics market, but remains higher than pre-pandemic average.

3 RCA data as of March 2024 for transaction volume and Hong Kong CPPI. Green Street data as of March 2024 for U.S. and UK CPPI. Note: CPPI (commercial property price index) are transaction-based indexes that measure sector-wide price movements on a GAV basis.

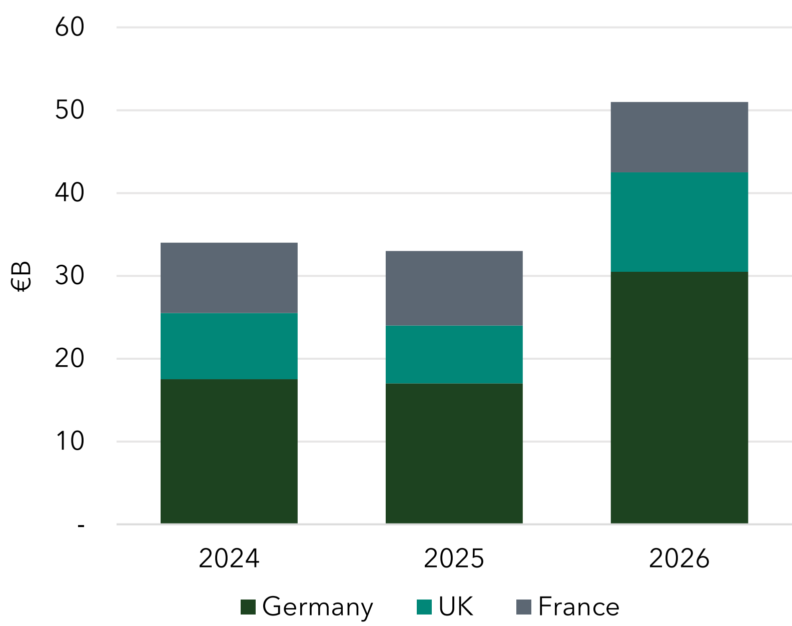
4 MSCI as of March 2024. Reflects commercial property loans.

With valuation declines, limited comparable sales and a U.S. 10-year government bond trading between sub-4% and 5% within months, bid-ask spreads continue to inhibit outright sales. Refinancings or extensions are possible outcomes. However, lender appetite has diminished as lenders address concerns within existing loan books, particularly pronounced across office collateral.

Financing and refinancing challenges expected to persist

Traditional lenders are increasingly interested in moving risk off balance sheets. Further, higher borrowing costs and valuation write-downs are resulting in paydowns required to facilitate executions. Europe is experiencing lower loan-to-values as a result of increased conservatism by traditional banks with financing gaps appearing and growing in Germany, the UK and France. Asia Pacific, while benefiting from relatively lower leverage levels and accommodative lenders, is anticipated to experience additional equity needs in certain markets and strategies.

European Refinancing Gap[5]



5 CBRE Research as of December 2023. Defined as the gap between original debt amount due at maturity and new debt available to repay / refinance.

Direct Secondaries – The Opportunity

Challenging market conditions have impacted most, if not all, sponsors. This includes elevated rates, conservative lending practices, upcoming loan maturities, valuation declines, and depressed fundraising activity. While some large sponsors have fared better, small and mid-cap sponsors have borne the brunt, particularly in terms of capital availability. This segment of equity and debt-constrained sponsors is actively seeking access to capital via the secondary market. And besides broad capital markets forces, limited partners are anticipated to play a behind-the-scenes role as they pressure sponsors to create realizations across their portfolios. These factors contribute to the "permanence" of the expected growth in direct secondary capital. We believe there is an attractive opportunity to provide solutions to a large and increasingly accessible universe of quality real estate with distinct advantages.

1. Select the Best

Opportunities to acquire high quality, re-priced assets are rising significantly. In order to fulfill capital requirements across portfolios, sponsors (and LPs) are seeking realization events in properties or portfolios that may otherwise not be available in a stronger capital markets environment. The high degree of selectivity allows investors to invest in business plans with identifiable asset-level value creation supported by cyclical tailwinds. This dynamic of choice also applies to underlying sponsors. Limited capital has broadened the sponsor universe seeking secondary capital. Therefore, investors can similarly be judicious in partnering with best-in-class, specialist sponsors in target markets.

Capital constraints are generating opportunities to be highly selective

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We believe direct secondaries offer the most direct (pun intended) path to acquiring quality assets in target markets with best-in-class sponsors. Transactions are typically concentrated, comprised of a single asset or a small two-three asset portfolio recapitalization. Contrast this with traditional LP secondaries in which "good" and "bad" properties are mixed within a single portfolio position. Although there are exceptions, tail-end assets in particular can fall into that latter category of "bad". The point being we expect a wide distribution of winners and losers across individual assets and property types more broadly. In the current market environment—dissimilar to the decade preceding COVID—the tide may not lift all ships.

2. Construct the Preferred Portfolio

Portfolio construction matters, especially in a global secondary strategy. Concentrating in specific demographically or technologically driven sectors may be a winning investment strategy. In our view, this includes opportunities across living, supply chain management and the new economy. Nonetheless, diversification is still important in this context and should not be ignored. Diversification can provide a number of potential benefits including creating a portfolio with underlying assets that perform differently or are otherwise less correlated. The diversification that can be achieved through, for example, the acquisition of a portfolio of fund stakes can be meaningful—measured by a secondary buyer's look-through ownership across tens to hundreds of assets. However, it is often the case that secondary buyers in the traditional fund stake format are price 'setters' but asset 'takers'. Perhaps now is the time to be both a price and asset 'setter'.

Portfolio construction matters, especially in a global secondary strategy

We believe direct secondaries provide the cleanest approach to constructing a preferred portfolio with investments that fit neatly into highest conviction strategies. Rather than investing into a diversified portfolio via a fund stake acquisition (and perhaps getting exposure to a less desirable sector or market), direct secondary investors can tailor exposure to what they believe to be the most attractive assets, geographies or strategies that a given sponsor is pursuing. Although traditional fund stake acquisitions allow you to "discount" unfavorable assets or sectors, buyers ultimately are beholden to the rigid constructs of existing portfolios. This can be particularly burdensome in today's environment where valuation uncertainty remains, and additional write-downs may be forthcoming. Said another way, the direct secondary strategy allows one to substitute asset selection for adverse selection.

3. Achieve Better Terms

What about continuation funds? These transactions typically result in increased concentration and have become an increasingly prominent component of the real estate secondary market. These are often highly competitive, fully marketed processes led by large sponsors. Intermediaries solicit interest from a wide range of market participants with existing LPs having the option to sell or retain ownership in the new vehicle. Lead investors set the price and terms. Control is typically maintained by the sponsor. This structure is one of the viable approaches to accessing the secondary market. However, there is an alternative approach with potential to achieve better terms.

Direct secondaries make it possible to prioritize opportunities with small and mid-cap sponsors where there is a real ability to structure select controls and governance rights. This can include approval of liquidity events, such as sales or refinancings, changes to business plans or future investments (if growth equity is a component). It also includes fees and economics, which in our experience are discounted relative to those of the sponsor's existing investment vehicles. Most importantly, let's not forget about the recapitalization price, as the basics of real estate investing still hold true for direct secondaries: basis is important. Real estate secondaries have historically been synonymous with the double-digit discounts achieved when acquiring traditional fund stakes. However, while pricing benchmarks may differ for direct secondaries, the resulting outcomes often “rhyme”. Pricing for direct secondaries is more granular and bottom-up, and the “discount” can take multiple points of reference and require more rigorous analysis: original project cost, latest (and often lagged) external appraisal, upcoming or pending valuation, materially de-risked business plans, etc.

Structure transactions with small and mid-cap sponsors with favorable terms

4. Secure Alpha

The easiest way to measure alpha generation is with relative performance. There are select large-cap sponsors that have and are expected to continue to generate strong performance. This likely includes groups with meaningful scale, global presence and deep benches of investment, asset management and development expertise. Scale is a powerful tool that can be utilized to understand broad market trends, more efficiently manage portfolios and participate in the part of the market that requires capital intensity. However, on average, smaller groups have generally outperformed (by over 400bps of IRR) over the past decade or so according to performance data from Preqin. [6]

Direct secondaries offer a means of accessing these outperformers. In our experience, we have similarly seen strong performance from groups that grew up with operating or leasing backgrounds. Their platforms may have been created with vertical integration in mind, preserving control throughout the investment and execution process. Due to size, strategies are highly focused and allow sponsors to be nimble across investment opportunities. It also provides opportunities to compete against other small and mid-cap groups that are less experienced or sophisticated.

Small and mid-cap sponsors have generally outperformed

6 Preqin data accessed July 2024. Includes value-add/opportunistic funds. Small and mid-cap funds defined as funds <$500M in LP commitments. Large cap funds defined as funds >$500M in LP commitments.

Direct Secondaries – The Key Challenge

Real estate secondary market participants have the opportunity to be a strategic partner to sponsors in the current environment. However, sponsor selection is expected to be a key determinant of success going forward. Strategic positioning within each geography and the ability to access proprietary deal flow are important attributes outside of track record performance and team stability. Further, sponsors' familiarity with the secondary market and sophistication provide a more efficient investment experience. This includes but is not limited to internal controls and procedures, reporting standards and understanding of economic alignment. Each region provides its own opportunities and challenges. As such, investors with dedicated regional investment teams are more likely to maintain the relationships and understand regional nuances required to action the most attractive investment opportunities.

Local investment teams are required to navigate investing nuances across regions

The U.S. has more than 1,400 real estate fund sponsors as of 2023 with combined assets under management approximating $1 trillion, or two thirds of the global institutional real estate market.[7] This creates an enormous investment pipeline into the most liquid market in the world. Investment approach varies widely including specialist, vertically integrated owner-operators to large/mega cap fund sponsors and those in between. In our view, abundance of choice results in increased difficulties for smaller and less experienced secondaries investors to identify sponsors with true differentiation.

In Europe, the real estate sponsor landscape is characterized by a high degree of concentration of a handful of mid-cap to large pan-European sponsors based out of London with regional teams or operating partners located across the continent. The spin out of senior partners or principals from those pan-European sponsors to create focused thematic platforms is another source of partnerships for secondaries players. Additionally, there are a number of vertically integrated institutional sponsors (sharp shooters) who have expertise within specific countries and/or sectors. Access to these groups may be challenging for some limited partners due to both operational and cultural barriers. Additional complexities for new entrants include intricacies of tax and currency management.

In Asia Pacific, the sponsor and investment universe is very diverse and nuanced. Pan-regional sponsors are overwhelmingly international with only a handful of Asia-headquartered sponsors primarily based in Hong Kong or Singapore. Single market-focused sponsors exist primarily in Japan, Australia and South Korea. Japan and Australia have seen the greatest proliferation of mid-market sponsors that have underwrite-able teams and track records and in many instances were formed with professionals that have spun out of larger organizations. Language, culture and cost of capital keep many local sponsors focused on domestic investors.

7 Preqin data accessed June 2024.

Conclusion

The real estate direct secondary market is expected to continue its growth trajectory. Various market sources estimate average annual 2021 – 2023 real estate direct secondary transaction volume of ~$7.5 billion.[8] However, in our view the market is significantly larger even today. Many direct secondaries negotiated bi-laterally typically with small and mid-cap sponsors are likely not reflected. These transactions are consummated without intermediation and volumes are unreported.

We anticipate this period of dislocation to continue expanding sponsor appetite to retain assets and continue value creation strategies. Sponsors' understanding and acceptance of direct secondary structures are expected to undergo a step change in the real estate industry as we navigate the beginning of this next real estate cycle. At the end of the day, naming conventions for transaction structures are less relevant for a sponsor. Sponsors will continue to seek flexible, like-minded sources of capital to capitalize on new opportunities and provide liquidity solutions for existing assets. Secondary market investors with a proven ability to execute as long-term, repeat partners are well positioned to play a permanent role in a competitive capital-raising environment.

8 PERE and market participants as of February 2024.

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