Taking a Second Look at Real Estate Secondaries

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Anu Rajakumar: Real estate is a broad and multi-faceted asset class. Historically, real estate has posted low correlation to stocks and bonds, has the potential to provide inflation protection and the opportunity to generate stable income. But private real estate tends to have long holding periods, with real estate funds typically lasting between seven and ten years, which is why the secondaries market can be particularly attractive both for sellers, whether they're high net worth or institutional investors, as well as buyers. But the market is still relatively small. According to a Preqin survey, in September 2020 real estate secondaries accounted for less than three percent of all real estate assets under management. So what lies ahead for the real estate secondaries market and what complexities should investors be aware of as they consider an allocation to this asset class? My name is Anu Rajakumar, and to help me answer those questions and more I'm joined today by Scott Koenig, managing director in real estate secondary strategies. Scott, thanks for coming on the show.

Scott Koenig: Thanks for having me.

Anu: So let's start with a bit of an overview. Scott, what are real estate secondaries and what role do they play in the broader real estate investment landscape?

Scott: Sure. Well, uh, historically a traditional real estate secondary opportunity is one in where a secondary buyer provides liquidity to a real estate investor who might un-, otherwise have that liquidity from their underlying real estate investment. Typically it's in a closed end, private equity style fund with no rights to redeem, and that particular investor in year seven or eight of what is normally a ten-year life wants liquidity that they're not getting from the underlying investment and then turns to the secondary market for that liquidity. The market's evolved, and so there are different types of transactions, including a type of deal called GP-led recapitalizations, which is where that sponsor of that underlying fund vehicle seeks to actually create a liquidity solution for all of its LPs without selling its assets, and that's become an interesting part of the market as well.

Anu: All right. Truly, that's a great overview. We're going to get into that GP-led component in just a minute but want to quickly talk about disruption within the real estate sector. How has real estate secondaries evolved particularly during and since the COVID crisis?

Scott: Well, real estate secondaries tends to thrive in markets that are pretty volatile and where LPs are looking for liquidity because they're not g-, necessarily getting it from their underlying investment. It might be in markets that are rising, where they want to take profits from a illiquid investment and put it into something else or it could be in a market that's declining, where they want to take their money out of something that they don't see great prospects for and reinvest it elsewhere. So frankly, we've seen real estate secondaries perform in both up and down markets. Now, COVID obviously threw a curve ball into the marketplace. Certain sectors have done really well, other sectors have done really poorly. Each individual opportunity and each individual investor has different considerations when they're looking at their particular investments, but nonetheless it's created volatility. And volatility is what I think has driven real estate secondary volumes. And that's true whether you're talking about the traditional single LP who wants liquidity from their investment or for the GP who's looking to create some liquidity for all of the LPs in his fund.

Anu: Sure. Now, Scott, you mentioned some sectors have done well, others haven't. Could you just highlight which sectors have performed fairly well during and maybe just after that COVID crisis period?

Scott: So it's been a pretty diverse series of outcomes across the entire real estate spectrum, and it's really hard to, say, make an aggregate statement about where real estate markets are just because there is such a disparity. Some of the trends were there before COVID and COVID just accelerated it, and some of them were brand new. Right. I think in terms of sectors that have performed really well, logistics is probably the one that comes to mind first and foremost, which is a trend that was happening pre-COVID. The rise of ecommerce was a big driver, but COVID really accelerated that tremendously, it also disrupted supply chains which caused even more demand for logistics properties. So that's been a-a huge winner post-COVID. Multi-family and single-family rental, for instance, also, uh, folks always need a place to live. Some of the new supply was disrupted a little bit during COVID and you've seen tremendous demand for housing, for rental housing, you've seen, uh, house prices spiking, rents growing. So that's been a-affected positively. On the other side of the spectrum, obviously retail was challenged pre-COVID. I think COVID has made that even worse, especially for certain types of retail in a class B or B minus Mall is got an, uh, even worse outlook today than it did maybe pre-COVID. Hospitality, hotels had a mixed experience. I think certainly going forward business class hotels and people relying on business travel are going to have a little bit of a longer recovery. And in fact some folks aren't sure that you'll recover completely. And office too, especially commodity-like office in CBDs and maybe older B-quality office I think has a-a particularly hard road going forward. So there's, as I said earlier, a wide disparity of impacts a-across the sectors, but again that creates volatility and that creates opportunity.

Anu: Absolutely. No, you're very right there. So let's circle back on the shift towards GP-led recapitalization. Now this is a shift from maybe more traditional LP-led transactions. So maybe just explain a little bit more about this, you know, so called disruption and explain how GP-led deals are different to LP-led transaction and what are the benefits, maybe the pros and the cons for an investor like yourself?

Scott: So GP-led opportunities are a form of secondary deal. Certain of them will have very similar dynamics in terms of underlying assets that might not have the liquidity in current property markets. They have maybe a relatively short business plan remaining, but because you're just happen to be at the end of the fund life some form of restructuring, extension recapitalization needs to be done. And in those circumstances it could be very complementary secondary transaction, or a secondary buyer provides capital, again, not to just one LP, but basically provides it to all LPs looking for an exit, and it really can be a win-win-win where exiting LPs get the liquidity that they want, the GP gets more time to execute on their business plan and the secondary buyer gets an interesting new investment with potentially attractive returns and an attractive underlying portfolio. So there's certainly we think a lot of benefits to the marketplace, and I think most folks have now woken up to that opportunity. So GPs and especially real estate GPs have become much more aware and accepting of that, and we're seeing a lot of that opportunity in the marketplace. LPs have become quite sophisticated and kind of understand what those represent and can now react to the quicker. And the secondary buyers I think has become a lot more evolved in terms of how we underwrite them and structure them. And so going forward I think most folks agree that this will be an important part of the market. That said, there's other things to be concerned about. A lot of these transactions can occur with assets that maybe have a longer horizon to them, maybe they have a bigger business plan that is required for them. And in those cases they might not look as much like a secondary, as a traditional secondary. They can also be pretty concentrated. They might have a very small portfolio of assets. So you have to be careful I think when looking at the GP-led market for deals that have secondary characteristics, I think they can be a very complimentary part of a secondary strategy. There are other deals which start to veer into direct-like, higher risk real estate investing, which is fine, but I think you just need to be cautious of that and conscious of that in your secondary pool of capital.

Anu: And I appreciate that particularly I think in the context of, you know, win-win-win –

Scott: Right.

Anu: – which I'm sure our listeners ears perked up, but, uh, always good to balance out some of those, um, things to be aware of. Uh, maybe just continuing on that line, additional risks, maybe more global, macro-economic risks that, uh, investors should be aware of as they think about real estate secondaries.

Scott: So there's clearly plenty of risks on the horizon. I think there always are, but today obviously we're conscious of where interest rates are. They've been low for a long time, they've threatened to creep up. Um, so where that will impact cap rates going forward is always a concern of ours. Inflation also is not surprisingly risen, definitely real estate has elements to it, certain asset classes especially. That can be beneficial during periods of-of inflation, but nonetheless you need to be conscious of what that means for how it impacts interest rates and therefore cap rates. We are not making five or ten-year investment bets on what we think markets will do over the long-term. It's a much more short-term strategy around a very specific set of identified assets. As a result, it becomes a bit more plausible, I say, to forecast what a cap right might be 18 months from now as opposed to seven to ten years from now. So I'd say one of the things, again, that we like about secondaries is just shortening up of the duration, uh, an-and thereby de-risking it a bit. You know, and I think there's just generally always risks in real estate markets that have to be evaluated as you make investment bets.

Anu: Sure, absolutely. And now, Scott, I know that you-you look at opportunities both in the US, as well as outside the US and Europe. Can you just compare and contrast opportunities that you're seeing in Europe as well?

Scott: So there's plenty of markets out there and micro-markets and property sectors that might resonate in one geography or another. And what we found is that having a broad funnel, being able to see opportunities in as many places as possible can unlock t-the most attractive opportunities. Clearly in Europe, there's 25-plus countries, tax regimes, legal systems, languages – that creates inefficiency, inefficiency creates opportunity. And so for, especially for, a secondary strategy where you are thriving on particular opportunistic situations, trying to find motivated sellers with good assets that have some reason to exit other than poor quality of asset, you need to be nimble and you need to be looking under every rock and stone.

Anu: Perfect. I think that that helps bring everything to light. Now, Scott, as we start to wrap up here, I'd love for you to share some takeaways for our listeners, particularly given that this is a small area of the market that folks may be thinking about in terms of asset allocation. What do you want our listeners to walk away with today?

Scott: Well, I think the market has evolved a lot over the past five to ten years. It's followed in the trajectory of private equity secondaries, which is a bigger and older market. Uh, and what we've found, uh-, some po-, some folks, when they first hear about real estate secondaries intuitively think, "Uh, it's a distress play or it's a cyclical play." And what we've definitely found and we're really modeling this off of what we've seen in private equity is that this is a long-term play that's very durable. It's not about taking advantage of short-term distress. This is about providing a solution to these LPs. So we don't think it goes away. And in fact as we look at the volume of funds that are out there and the amount of AUM within those funds, it's never been as high as it is in –today, in the real estate market. And that's the target universe for secondaries going forward. So we do have a positive outlook in terms of the number of opportunities that are out there, we believe LPs and GPs will continue to turn to that market, and therefore we think it's an attractive place for our clients to be.

Anu: Perfect. Thank you very much. Now I have a bonus question for you, [Chuckles], before we finish. Uh, you know, here the US Thanksgiving is just around the corner. So, Scott, I'd love to know what is your favorite part of the Thanksgiving meal?

Scott: Well, that would be mashed potatoes, hands down.

Anu: I'm totally with you on that one.

Scott: [Laughing]

Anu: I'm a fellow mashed potato fan myself, as well. Well, I hope you enjoy the upcoming Thanksgiving holiday. That will do it for this episode. Scott, thank you very much for sharing your insights on-on real estate and real estate secondaries, specifically. It sounds like there are some terrific opportunities ahead in this growing market, so thanks again for joining me today.

Scott: My pleasure.

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