KEYNOTE INTERVIEW

A need for hands-on asset selection

Private equity investors eye lucrative opportunities in an evolving real estate secondaries landscape, says Neuberger Berman's Scott Koenig

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Once seen as an escape hatch for troubled situations, the real estate secondaries market has evolved into something worth considering for every private equity investor. A liquidity crunch wrought by the global financial crisis 15 years ago saw the asset class rise to prominence as illiquid real estate fund investors looked for an exit ramp. Since then, growing awareness and acceptance of the sector, combined with new deal structures like GP-led recapitalizations, has caused volumes to skyrocket.

Scott Koenig, managing director and head of real estate secondaries at Neuberger Berman, is putting three decades of commercial real estate experience to work capitalizing on opportunities in the rapidly growing real estate secondaries market. He breaks down how various deal structures can create attractive returns for investors who can understand and evaluate the underlying risks.

Q What is the current opportunity set in the real estate secondaries market for investors?

Real estate secondary investors are providers of liquidity, and liquidity is at a premium right now. Fund investors have not been getting significant realizations from their real estate portfolios recently, and I am not sure this will change significantly in the near future. So, people who are looking for liquidity and not finding it are turning to secondary markets. As a result, we think the opportunity set for real estate secondaries is poised to be as significant as it has been for some time.

A traditional secondary investment involves an existing LP in an illiquid investment vehicle who wants an exit before the vehicle is wound up and sells its commitment to a secondary buyer, typically at a discount to underlying value. Perhaps not surprisingly, there are a large number of investors with commitments to legacy real estate funds who would like to liquidate now if possible, which presents a substantial opportunity set for secondary buyers to evaluate. Of course, the quality of the underlying assets and what these may be worth in today's markets can vary widely, so secondary buyers do need to be cautious about the deals they are pursuing.

Another common type of secondary deal is a GP-led recapitalization, where the sponsor of a vehicle works directly with one or more secondary buyers to provide a liquidity solution for multiple existing LPs while retaining control of the vehicle's underlying assets. Similar to the traditional LP-led market, there is significant and growing demand in this portion of the real estate secondaries market, with many GPs feeling pressure to return capital to legacy investors.

Many of these situations can offer secondary buyers an attractive entry point into a mature, mid-life portfolio. At the same time, though, it can often be difficult to agree with GPs on the value of some of those portfolios today, especially when activity in the direct markets is as slow as it has been, so executing the right deals at the right price can still be challenging.

Q How do you view the relative appeal and risks of LP- or GP-led deals today?

We believe both of these transactions can be interesting, and even complementary. They have different risk-return profiles in our view, though. LP deals are typically shorter in duration and tend to have more diversification than GP-led deals, both of which should lower relative risk. They also are typically bought at a discount to fair value, not because the assets are necessarily overvalued but because that is the price the seller must pay for liquidity. When LP-led deals are pursued well, we think their characteristics can create an attractive risk-return profile.

Today, there is clearly concern that fund valuations are still too elevated, and therefore that discounts to value may be illusory. That can certainly be a concern in some situations, but we think this can be mitigated by doing your own re-underwriting of the underlying assets and looking to buy them at a discount – not just to the GP's reported mark, but to what you think the assets could sell for even today.

Secondaries buyers should also be wary of buying interests in funds that have problem assets which may have a lot further to fall. In this case, asset selection is critical, and we think it is

Q It sounds like finding the right secondary deals goes beyond what you can see in a spreadsheet or a fund snapshot. Is that an accurate assessment?

That is absolutely our view. With secondaries, mitigating risk requires a focus on asset selection and fundamental analysis. There is danger in not fully knowing what is in the underlying fund you are buying, or not having your own view on value. Buyers need to be able to look past a GP's reported valuation and perform their own underwriting analysis, which should include assessing the strengths and weaknesses of individual underlying assets, critically analyzing their capital structures, pulling comps and reviewing market data, and speaking to local market professionals and other industry professionals.

Some funds and sponsors are pretty opaque and might not allow for this type of analysis. Other opportunities are so large and diversified that they necessarily become a top-down exercise involving portfolios that, by definition, are likely to carry more beta-like risk. But we believe that by being patient and disciplined, one can find situations with more-than-sufficient transparency, and where one's resources and relationships can occasionally even provide an informational edge.

important to be patient and measured in one's deployment, especially today.

We've observed that GP-led deals can also be quite attractive, as they can provide secondary buyers the opportunity to better select the assets they want to invest in, and they often allow for a deeper underwriting and potentially even some influence over control versus LP-led deals. On the other hand, the point of a GP-led recapitalization is usually to give the manager more time to manage and hold the assets, so in our experience, they can have a longer cashflow duration than traditional LP-led deals.

Often, the GP is also looking to continue a high growth business plan, potentially with fresh blind pool capital, so risk levels can be higher. Additionally, while entry valuations can be attractive, GP-led deals are not often executed at the same type of discounts that can be obtained from a single LP seller who has its own idiosyncratic motivation for exit. For all these reasons, we think GP-led deals sometimes carry a different risk profile than LP-led deals, and they need to be priced accordingly.

Because bid-ask spreads in the direct property markets remain fairly wide right now, one of the risks secondary buyers may find with GP-led deals lately is sponsors asking the secondary market to recapitalize assets at valuations that are at or above what the direct market is willing to pay at the moment. In these cases, we think secondary buyers need to be cautious.

Q What factors are important to consider in those real estate sectors where values have not fallen as far as industry averages might suggest?

We believe there are pockets of value and opportunity in the market today. The headlines might paint the commercial real estate sector with a single brush, but we find when you look through the headlines, you see some sectors in better shape than others. Certain assets in those sectors can be stronger or weaker, too. Instead, we feel a bottom-up opportunistic strategy can allow secondary buyers to find real value in specific assets and specific situations.

We believe there is also value in many alternative asset classes, including cold storage, marinas and parking. When we see people running away from commercial real estate generally, we feel it can be a good time to find opportunities.

Q How can a real estate secondary buyer get comfortable with discounts in a period of falling valuations?

Investing during a period of dislocation and falling valuations can be uncomfortable. However, we believe real estate secondaries can be an excellent way to take advantage of the current environment. As direct property marks are taking more time to stabilize and fund managers are slowly adjusting NAVs to the new rate environment, the emphasis comes back to asset selection and fundamental analysis.

Not every situation is wise to step into, and on those that may be interesting, it is still hard to evaluate relative attractiveness purely by the size of the discount to the GP's reported mark. But if you can be selective and take your own view on value, we believe well-positioned secondary buyers can take advantage of the need for liquidity in real estate markets to gain exposure to quality assets at very attractive pricing.

Some people have expressed concern that investors should wait until the valuations fall further before jumping in. On the contrary, we think that trying to time the bottom of the market risks missing many compelling opportunities out there today, and that it is precisely when sentiment is negative that well-positioned buyers can find real value. ■

"Fundamentals of supply and demand are still healthy in many property types, especially in sectors like single-family rental, industrial warehousing and data centers"

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