# Real Estate Secondaries: A Diamond in the Rough Market?

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**Anu Rajakumar:** Real estate secondaries is an asset class that has grown considerably over the last decade but has really entered the spotlight more recently in a period where liquidity significantly retreated from the real estate sector. But as investors grapple with broader concerns about real estate values, what makes real estate secondaries an attractive solution? And what are some of the risks that investors should consider?

My name is Anu Rajakumar, and today I'm pleased to welcome back to the podcast Scott Koenig, head of real estate secondaries at Neuberger Berman, to share an update on this attractive area of the investment opportunity set. Scott, thanks for joining me today.

**Scott Koenig:** Thanks, Anu.

**Anu:** So Scott, last time I had you on the show, it was 2021, and of course, a lot has unfolded since then, particularly the macro environment on the interest rate front. So let's hear a little bit about how real estate secondaries have been impacted over the last few years.

**Scott:** Yeah well, thanks again for having me. The markets have changed a lot for real estate broadly, and of course for real estate secondaries. In 2022, interest rates started spiking, which caused cap rates to move up valuations in real estate, pretty much across the board to drop. And that's caused property transactions to dry up as buyers and sellers waited to see, and where the cap rates would ultimately settle, where valuations would move too. And that created a real period of illiquidity for folks.

On the one hand, that's provided a real opportunity on the secondary front. On the other hand, there's a lot of risks and challenges in a marketplace like that. Again, we're not necessarily taking a view on where we think cap rates and interest rates are going to go. So in a period where, there's a lot of uncertainty, it's difficult to transact.

However, we've seen so many investors, limited partners, and also GPs looking for liquidity from their real estate portfolios over the past 18 months and not able to find it. So it's a time of challenge, but also a time of opportunity. I think there's also, an interesting opportunity, in the next couple of years as interest rates hopefully stop rising, cap rates do come into focus, and sellers and buyers, a little bit more ready to transact.

**Anu:** Okay, great. Thanks very much, Scott. That's some good background. Now I know there's some great opportunities within real estate secondaries. However, there is some investor skepticism. So talk us through some of the main concerns that folks have when you're speaking to them about this particular asset class.

**Scott:** Well, we're certainly hearing, a variety of concerns. I think probably the two that we hear most often today are, first of all, real estate valuations are too high. So how can you be comfortable in the secondary market that you're buying an appropriate pricing? The second is just generally related to risks in the real estate market broadly. And I would say in both of those situations, both of those concerns, we tend to agree.

Valuations in real estate funds are too high, in our opinion. They have been coming down, but whether you look at core funds, the NPI index that's released quarterly, I think still shows a cap rate that's probably unrealistic and still needs to increase. So I think you're going to continue to see write-downs in core funds for the next couple of quarters; but also in value-add opportunistic funds where it's not as clear where valuations are, but almost certainly, they're too high. They just haven't come down very much, even though interest rates have spiked.

So when we look at fund valuations, they're elevated. And in order for a secondary buyer to be comfortable, the implied discounts are pretty steep. And so we really need to be careful about the things that we're buying. Frankly, you can't expect volumes to be particularly high in an environment like this because the bid-asked spread is pretty steep. The discounts are wide, and there aren't that many sellers who are willing to accept the big discounts.

I do think also broader risks about real estate are valid. There are absolutely sectors of the real estate industry that are going through some significant changes. US office as an example, I think has a long way to fall still, unfortunately. So in the secondary market, that's a real challenge. It's not something that we've been able to get comfortable with.

Even previously, strong property types like multifamily, I think are still going through some challenges. Rent growth has slowed dramatically. It's even reversed in some markets. Cap rates meanwhile have moved up. But again, with fund valuations, probably not as much as they should have. So as we look at opportunities in those sectors in the secondary market, we think there's challenges.

So I think in response to both of those issues, whether it's overvalued funds or risks in the real estate market, our view is you really need to be focused on the types of assets that you're buying. If you're buying a big broad diversified portfolio valued at yesterday's marks, that's pretty challenging. Either you're buying it at a steep discount, which the seller's unlikely to want to pursue, or you're taking some real property level risk, macro fundamental, beta-like risk on the real estate market, neither of which feels great. Instead, focus on specific situations, specific assets, specific funds, really trying to find opportunities to buy good assets that have not fallen as much as the averages, who may be valued more fairly than what the indexes might suggest. Sellers that are maybe more motivated than an average seller. and if you can be selective, if you can be patient, we think you can find real opportunities, just requires you to be quite disciplined.

**Anu:** You know, Scott, you've just described needing to be focused on what you're buying, what you said sounds a lot like you have to do fundamental analysis on these assets, which notoriously is quite challenging to do in secondary markets. So tell us how do you do that fundamental analysis essentially?

**Scott:** Sure. Not every situation allows you to do fundamental analysis. Clearly, there are opportunities in secondaries as a buyer where it might be an opaque situation, the GP reporting might not be very good. You might not have clarity on exactly what's in the portfolio, and those tend to be situations that we would shy away from. And I think it's really challenging and I think one of the main risks of secondaries broadly to buy into a portfolio that you don't fully understand what's in it. As a result, we're focused on situations where there is transparency. Some funds, the reporting is quite good. Some funds, we have good relationships with the GPs and can get access to information that allows us to really understand what we're buying, which you can then supplement with your own analysis, your own, local market research, speaking to local professionals, getting local market data. And as a result, really do have comfort about the types of assets that you're buying.

We also think focusing on more targeted situations, maybe smaller transactions or more concentrated portfolios where you're not taking, beta-like risk on a hyper-diversified portfolio, which almost by definition is going to be beta-like, but instead focusing on situations where you screen out assets that you don't want to own, and you focus on things that you think can perform.

Again, that means you're going to have to pass on certain deals, which I think is a realistic scenario. I think you have to-to recognize that not every transaction might work for you, but you can find opportunities to invest in situations where you can get real comfort on the underlying assets and really undertake your own fundamental analysis.

**Anu:** Any chance you could share an example of where fundamental analysis really helped to make a clear decision?

**Scott:** Absolutely. I'd say we really need to understand the underlying assets down to the level of the specific building, the specific, rent and growth expectations that we have for those assets, and then the exit cap rates. And when we do that, we're able to evaluate not only where the GP is maybe marking that asset today, and maybe they're marking it too aggressively; but if we can do our own analysis and mark that asset to a cap rate that we think is appropriate. We think you can really drive real value in real estate secondaries. It's an ability to reprice the situation to what we think the market is telling us today, and basically using the secondary market to get access to that, where you wouldn't be able to get access to it in the direct markets, right now at the same pricing. Situations involving multi-family assets, single-family rental portfolios, industrial assets, certain alternative asset classes, where we believe on the secondary market, through the discount and through a secondary transaction, you can come in at a cap rate, your own entry cap rate that is meaningfully higher than even what today's cap rates are showing in the property markets.

That's, to us, the real attraction of the secondaries market. Again, it requires you to find situations where you can do that analysis and take a view on what your entry yield is, but when you do find those situations, we think you can get real comfort that you can buy assets for frankly below what they're intrinsically worth.

**Anu:** Yeah. Sure. And that value proposition is so critical for investors who can be that liquidity provider. The last time that we spoke back in 2021, we spoke a little bit about LP-led versus GP-led investment opportunities. Give us an update. What are you seeing in terms of where some of the value can be found?

**Scott:** Sure. We're seeing opportunities in both types of transactions for sure. GP-led has certainly been an evolving type of transaction and you're seeing more and more of that, and I think it's becoming more and more accepted in real estate. So there's plenty of opportunities out there in GP-led, but LP-led continues to be attractive. We've always maintained that there's sellers in illiquid real estate vehicles, through all parts of the cycle. We think that's a long-term secular opportunity to find ways to invest and to buy LP-led.

In this environment, although bid-ask spreads have been pretty wide and discounts have necessarily been wide, given where valuations were, and where the outlook for real estate has been. Nonetheless, we found plenty of limited partners who have invested in illiquid structures that want liquidity. And if you're patient and selective, we've been able to find some quite interesting opportunities to buy at discounts. And I think that persists. I think if you're able to focus on specific opportunities, you can continue to find those deals.

So we think LP-led, transactions, even though volumes were almost certainly down in 2023 significantly, that there's going to be a lot of opportunities for that in the next part of the cycle. GP-led at the same time, we're seeing good opportunities there. Although one of the challenges we see in GP-led right now is GPs that are unable or unwilling to sell their assets in the direct property markets, given where valuations are and asking the secondary market to basically replace that capital and pay a similar price to what they would have hoped to achieve in the direct markets.

If it's a good portfolio or a good set of assets with a solid business plan, it could be attractive. But at the same time as a secondary group, I feel like you never really want to pay the same as you might in the direct markets. Otherwise, we would argue you should just go out and buy it directly. So you need, in our view, to drive a discount of sorts, in the GP side.

You need to be able to say that because of the GP transaction, because of the secondary construct, you're able to come in at an evaluation that's better than what you can get in the direct markets. We do find GP-led opportunities that are like that. We've also seen some GP-led opportunities where, frankly, we question whether we're actually getting value or whether we're just replacing the direct markets.

**Anu:** Yeah, that's an interesting paradigm actually that you're dealing with there. That's a great segue to my final question, Scott, which is just about your outlook for the space, what are some of the future trends that you think we'll see in real estate secondaries in the coming year and beyond?

**Scott:** Well, so first of all, I do think you're seeing real estate valuations come down across the private fund universe, which will facilitate more transaction volume. As the bid-ask spreads, it should allow sellers to transact. So I think that'll be a positive. I do think as well as interest rates have hopefully peaked, that's given visibility to buyers and sellers on what cap rates and valuations should be. So it's removed some uncertainty to the market and that should also help.

In the meantime, however, it's going to take time for markets to stabilize and for an equilibrium to be found. And so in that period, I think is when you can find some very interesting opportunities. I think one area that could be of interest in the next period is, preferred equity type structures or types of investments at the fund level, that kind of bridge that bid-ask spread. I think we'll see some more of those. But I do think just in general, the next couple of years will be very beneficial for providers of liquidity, which is what secondary investors are at the end of the day.

**Anu:** That’s a great place to end. Thank you very much Scott for sharing those thoughts. Before you go, let me ask you a quick bonus question, which has nothing to do with the episode so far. Tell us about what a typical weekend looks like for you these days, [which] can be hobbies or family obligations, or just your favorite way to relax.

**Scott:** Sure. I have three teenagers. So my weekends are generally revolved around driving between one activity and another, still soccer practices and birthday parties and going to the mall et cetera. So, I'm a chauffeur basically on the weekends.

**Anu:** I was going to say chauffeur on the weekend. Very, very good. A nice change from your from your Monday through Friday.

Well, Scott, thank you very much for chatting with me today. You know, you laid out a case for some of the reasons that real estate secondaries could continue to be an attractive area for investors. You know, you mentioned interest rates, potentially moderating fund valuations coming back in line and as you said, continued motivation from sellers seeking liquidity.

And I also just want to mention if you've enjoyed Scott's thoughts today I highly encourage you to check out the paper that he's recently written about real estate secondaries. It can be found on the Neuberger Berman website at nb.com. Once again, thank you very much for coming on the show, Scott. Appreciate your insights and for joining me today.

**Scott:** Thanks for having me.

**Anu:** And to our listeners, if you've enjoyed what you've heard today on *Disruptive Forces*, you can subscribe to the show via Apple Podcasts, Google Podcast, or Spotify, or you can visit our website, www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and offerings.