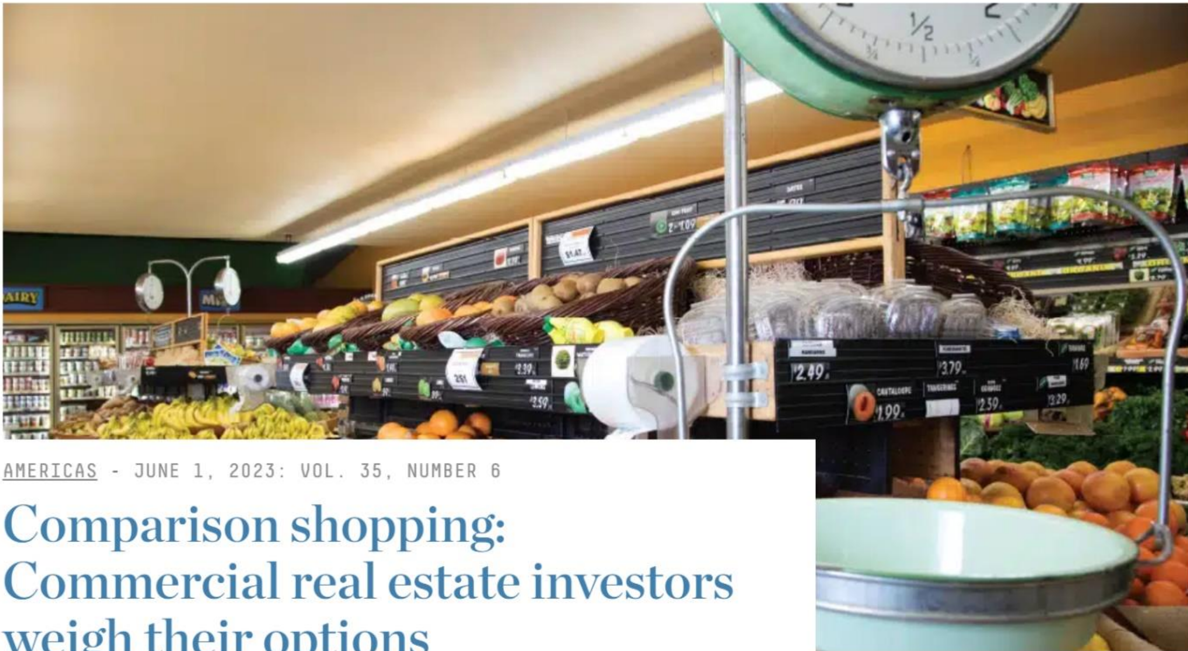

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Comparison shopping: Commercial real estate investors weigh their options

BY DENISE MOOSE

"Not too long ago, investors were looking for their managers to provide exposure to real estate quickly and at scale. Now, investors will want their managers to demonstrate that they have the skills and abilities to be highly selective and find the very best deals," says Chris Urwin, investment strategist, market analyst and researcher at Real Global Advantage.

The current environment offers many strategies for real estate investment. But with a wide array of available options, investors need to consider the desirability of different real estate strategies, such as core versus value-added or debt versus equity.

Investment strategy

One piece of evidence for investors' opinions on core property investing are the long redemption queues for the open-end core funds of the NCREIF Fund Index – Open-end Diversified Core Equity (NFI-ODCE). Does this mean investors are looking to shift away from core to other private real estate? Are they moving out of real estate entirely? Or is the concern overblown?

Jennifer Stevens, co-founder and managing partner at Alliance Global Advisors, thinks that despite recent headlines highlighting redemption activity in the open-end commingled funds and private nontraded REIT space, core real estate will remain a significant allocation in a private real assets investment program.

"In addition to the diversification benefits of real estate, the asset class provides distinct risk-adjusted returns supported by stable income from core real estate," says Stevens. "Due in part to appraisal-based valuation practices and the income component, real estate offers historically lower volatility compared to other asset classes."

In the current environment of rising interest rates, however, core property is less attractive on a relative basis. "Regarding positioning in investors' overall portfolio, the increase of interest rates during this Fed tightening cycle has decreased core real estate's yield advantage relative to fixed-income strategies," says Stevens. "As a result, investors may now consider rebalancing their core real estate allocation in favor of fixed income, reversing the decade-plus trend that occurred as interest rates declined to near zero."

Greg Eudicone, head of U.S. real estate client portfolio management at Barings, points out that most institutional investors take a long-term view with respect to their portfolios, so it's unlikely any investors would move out of the real estate sector entirely.

"That said, the term 'denominator effect' has become part of investors' daily vocabulary, as declines in their public portfolios have created an overallocation to their private portfolios, namely real estate," says Eudicone. "The redemption queues in ODCE funds are in large part an effort to rebalance portfolios to get closer to real estate allocation targets. There is also a component of allocating to other asset classes given the shrinking of the real estate risk premium as risk-free rates increase."

According to the NFI-ODCE's preliminary first-quarter 2023 data, open-end core funds saw a total gross return of –3.16 percent, driven by quarterly depreciation of almost 4 percent and depreciation of 6 percent for the one-year period.

“Depreciation only began in 2023 and has been slow to materialize,” says Stevens. “When we speak with investors, they generally prepare for a peak-to-trough decline in real estate values exceeding 10 percent across the primary property types. So, we’re not there yet. This is why investors are slow to deploy additional capital in the real estate space, specifically in pre-specified portfolios.”

Stevens notes that investors continue to be interested in the niche property types or unique structures that may produce additional economic benefits to investors without increasing the level of risk.

“While core pre-specified funds are currently out of favor, we expect that to reverse when values stabilize,” says Stevens. “Currently, value-add and opportunistic strategies are more attractive on a relative basis, as value-add and opportunistic vintages that invest during downturns have historically outperformed.”

For some investors, considering which strategies offer the most compelling risk-adjusted returns in the current environment has led them to look at value-added or opportunistic investments.

“Now is an excellent time to start looking at value-add and well-vetted opportunistic investments,” says Julia Boyd Corso, co-president and COO at IEC. “While distress is not common in multifamily in our target markets, we are identifying mispriced assets and less competition when bidding. False starts are common. Identifying such opportunities requires local expertise, deep relationships and value-add experience.”

But while some investors are looking for opportunistic openings, others have taken a pause.

“Lots of investors are in ‘wait-and-see mode,’” says Urwin. “Spurred by higher interest rates and near-term recessionary risks, there is a repricing under way, and there is a gap between the price buyers are willing to pay and the prices demanded by sellers,” notes Urwin. “Those that are being acquisitive are generally adopting a defensive mindset. Private equity real estate investors are favoring core over value-add opportunities.” Urwin says investors are generally looking for desirable, high-quality assets in established locations and for fully leased, rather than vacant, properties with long leases to well-capitalized businesses.

“It is hard to get comfortable taking on leasing risk right now, except perhaps in hot residential markets,” he adds.

Rising interest rates

Theoretically, the defensive attributes of debt may mean investors should favor it over equity at this point in the cycle, notes Urwin. In practice, however, little debt is being written, as transaction levels are low, and debt isn't necessarily accretive given current interest rates.

"Perhaps the most appropriate strategy at this stage of the cycle is to position for mispricing," says Urwin. "During a period of tightening financial conditions, someone somewhere will need liquidity fast. Distressed sellers will generate attractive opportunities for those with the capital and courage to act. Opportunity may be most likely to come as loans written in a very different environment – featuring higher values and much lower interest rates – require refinancing."

Rising interest rates seem to be at the forefront of everyone's minds, in the institutional real estate market or not. The rise in interest rates has affected perspectives on the desirability of different strategies and raised the question of what challenges borrowers are facing.

"The rise in interest rates has created a segmentation within the real estate market between strategies that easily allow for rental growth and those that take longer to reprice," says Jenna Sheehan, senior managing director, head of investor relations – North America, at Harrison Street. "Sectors that have short-term leases allow rents to reprice more frequently, which is especially valuable in today's inflationary environment, and investors understand that these sectors may fare better in the coming months and years."

She adds that rising interest rates also have affected the pace of investments. Investments that would have made sense a few years ago are no longer feasible with the current cost of borrowing. As a result, certain sectors have seen a dramatic fall in transaction volume, while resilient real estate sectors are continuing to see transactions take place due to continued access to financing.

Boyd Corso says greater uncertainty about debt costs, leverage levels, economic trends and valuations has reduced transaction volume meaningfully.

“This has put many investors on the sidelines,” she says. “Yet amongst all these obstacles, there is still strong demand for multifamily real estate, and the sector is expected to perform well this year despite economic headwinds. We believe the need for private equity will grow in multifamily, where debt is available but at lower levels than a year ago for both refinances and acquisitions.”

Sector selection

It is possible the distinctions of core and value-added or debt and equity are less important than the selection of the correct property sector, given how closely investment outcomes have been connected to property type in the post-pandemic era. A lot of discussion around strategy at present focuses on the differing outlooks for various property sectors.

“From a sector perspective, in addition to being impacted by the uncertain capital markets, the commodity office sector is also facing an obsolescence issue as tenants continue to evaluate the size of their footprint,” says Eudicone.

“Office markets, for example, face major challenges given the rise of working from home,” agrees Urwin. “Many residential markets, on the other hand, are proving resilient, reflecting the strong job market and ongoing wage growth.”

“Across various real estate strategies, investors are looking to minimize their exposure to areas that are directly correlated to GDP growth,” says Sheehan. “The consensus is that the outlook for strategies is currently more tied to sectors of focus, rather than whether they are core, opportunistic or value-add assets.”

She adds that Harrison Street is seeing interest across the risk/return spectrum, with investors looking specifically for strategies that are resilient and property types that will continue to have strong demand.

“Many of the investors we’re speaking to want to bolster exposure to demographic-driven alternative real assets, such as student housing, which have proven to have strong demand and fundamentals through market cycles,” says Sheehan.

Urwin says a critical role for successful strategists is differentiating between cyclical and structural factors of performance. As this downturn is primarily driven by higher interest rates, rather than a major change in the outlook in occupier markets, there is no need for a major reassessment of the thematic drivers investors believe in and build strategies around. But it is easy to believe in strategies when prices are going up. In most cases, investors need to recognize the cyclicality of real estate and maintain conviction in their strategies.

Declining values

Lastly, when comparison shopping, investors need to consider how valuations are being affected by the current market environment.

"Property valuations are being negatively impacted by the current environment, nearly across the board," says Eudicone. "Private real estate values, in typical fashion, have lagged their public-market counterparts; however, values have already been and will continue to be driven down as higher discount-rate and exit cap assumptions factor into valuations. Additionally, as nonvoluntary sellers emerge and transact at low price points, these market comps will factor into pricing for voluntary sellers as well."

He adds that value declines are top of mind for core property investors compared with noncore property investors because traditional noncore property investors are focused on achieving the best price once a property is stabilized, so less attention is paid to a specific noncore property's value while the business plan is under way.

Urwin adds that valuations are on a downward trajectory.

"Given that the repricing is driven by higher interest rates, it is impacting core and value-add investments in a broadly similar manner," says Urwin. "I have been surprised that the declines in valuations to date have been relatively modest. It means there is more to come. Absent a marked pivot in Fed policy, the downturn has a way to go."

Denise Moose is the special reports editor at **Institutional Real Estate, Inc.**