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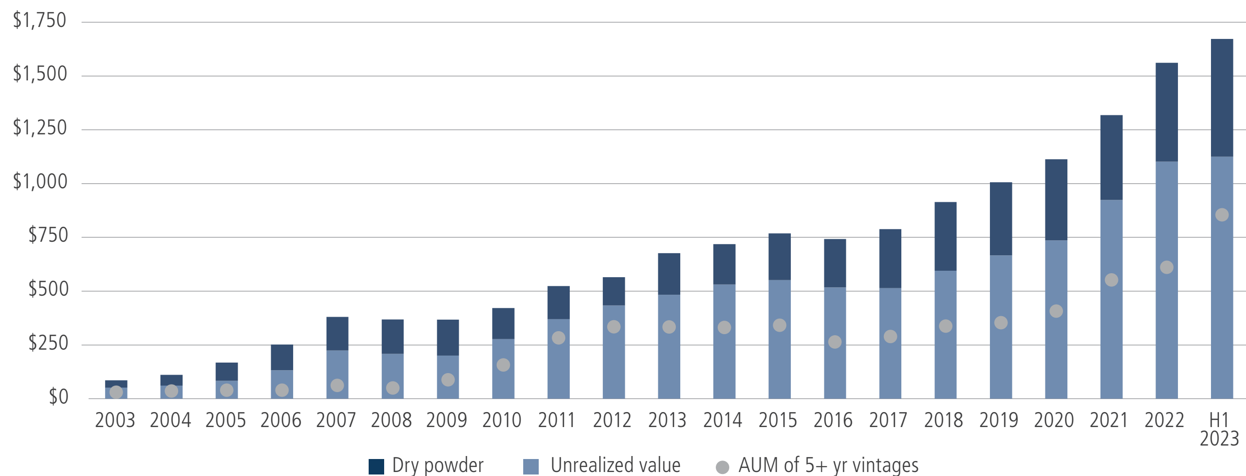
Real Estate Secondaries Today: A Discount to What?

Finding opportunity in a period of falling valuations

As liquidity has receded from the commercial real estate sector, interest in real estate secondaries has ballooned. The closed-end real estate fund universe has never been larger (Figure 1), but with many of these funds unwilling or unable to dispose of their assets in direct property markets over the past 12 to 18 months, we are seeing more and more existing fund investors (LPs) and sponsors (GPs) consider turning to the real estate secondary market to obtain liquidity.

FIGURE 1: AUM IN CLOSED-END REAL ESTATE PRIVATE EQUITY FUNDS ($ BILLIONS)

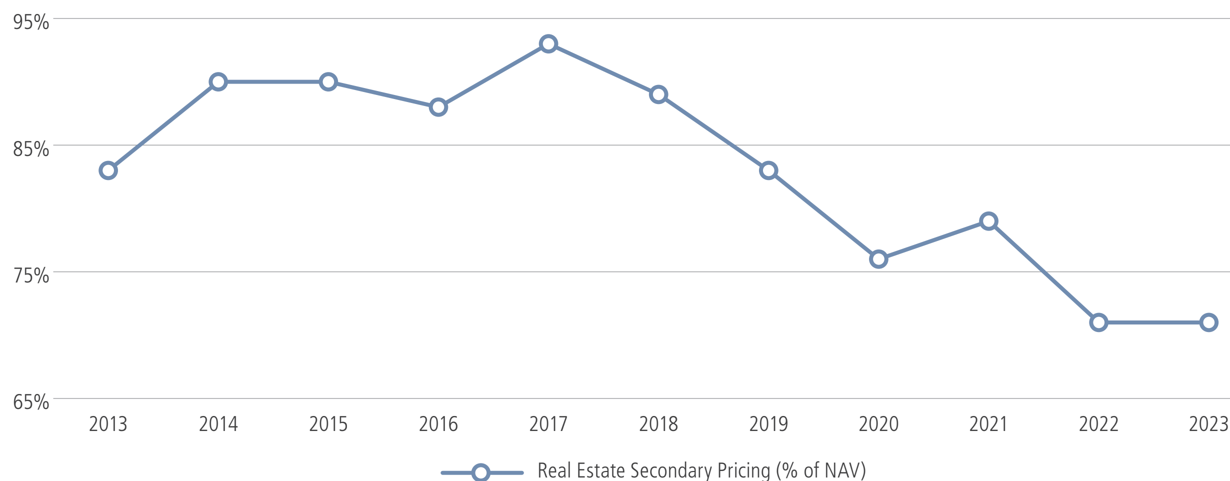


Source: Preqin (Dry Powder and Assets Under Management for Real Estate asset class) as of February 2024 (most recent data as of H1 2023).

Assets under management (AUM) within closed-end real estate funds are at an all-time high. AUM of funds raised five or more years ago—the target of most real estate secondary transactions—has also approached a record $850+ billion.

Potential secondary buyers are often drawn to one of the key benefits that traditional secondary investing has historically offered: the ability to acquire exposure to the underlying assets of a private real estate fund at discounts to reported net asset value, or NAV (Figure 2).

FIGURE 2: AVERAGE REAL ESTATE SECONDARY DISCOUNTS OVER TIME (LP PORTFOLIO PRICING AS % OF NAV)



Source: Jefferies, Global Secondary Market Review, January 2024.

According to Jefferies, discounts in real estate secondary transactions have averaged nearly 30% since 2022.

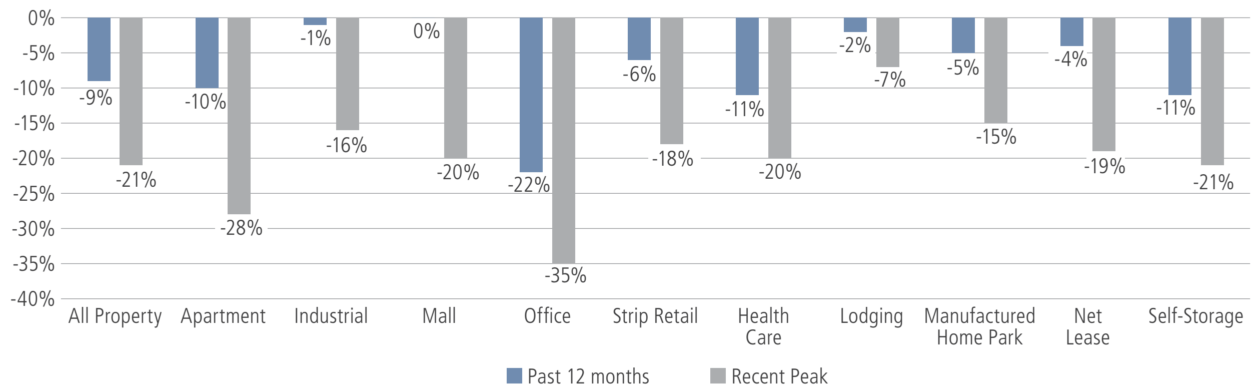
In today's environment, however, valid concerns that private real estate fund valuations have not yet sufficiently reflected the recent sharp declines in commercial real estate prices—and worse, that real estate pricing may continue to fall—beg the question: Is buying an LP interest in a fund or recapitalizing a portfolio at a discount to the GP's reported NAV really a bargain if the GP's NAV is unrealistically high? How can a real estate secondary buyer get comfortable with purchase discounts in a period of falling valuations?

Are We at the Bottom Yet?

Since interest rates began rising rapidly in early 2022, real estate prices have fallen across virtually all property sectors. Green Street's Commercial Property Price Index indicates that from a peak in March 2022 through January 2024, asset prices declined an average of 21% across the industry, ranging anywhere from -7% for hotels to -35% for offices (Figure 3).[1] The MSCI Real Capital Analytics Commercial Property Price Index generally reported smaller drops, but nonetheless registered a double-digit decline in its "all-property" index over roughly the same period.[2]

[1] Green Street, Commercial Property Price Index, February 6, 2024. The index seeks to capture the prices at which commercial real estate transactions involving institutional-quality assets are currently being negotiated and contracted.
[2] MSCI, RCA CPPI US, January 2024.

FIGURE 3: GREEN STREET COMMERCIAL PROPERTY PRICE INDEX – CHANGE IN COMMERCIAL PROPERTY VALUES BY SECTOR



Source: Commercial Property Price Index, as of February 6, 2024.

Now that the market seems to believe that the Federal Reserve is largely done hiking interest rates, and may even lower them in 2024, there are signs that real estate pricing is stabilizing; recent Green Street research suggests that private real estate is now more or less fairly priced when compared to current corporate bond yields and REIT share prices.[3] While no one knows what may transpire in 2024, and while certain parts of the real estate sector (e.g., U.S. offices) may have further pain ahead, the leveling-off of interest rates provides some hope that prices for most types of real estate are nearing a bottom. At a minimum, stabilizing rates are offering helpful clarity on where pricing may settle.

What About Private Fund Valuations?

A key problem facing those invested in private real estate funds, however, is that many of those funds have not yet fully reflected recent price declines in their reported NAVs.

It's difficult to generalize, since the universe of private real estate funds is quite diverse and opaque. But one area where there is some transparency—open-end core funds in the U.S.—helps to illustrate the disconnect between current real estate pricing and fund valuations. According to NCREIF, the average capitalization (cap) rate implied by the appraisals of properties within the NCREIF Property Index (NPI) was just 4.55% in 4Q 2023.[4] While this represents a meaningful increase from the NPI's sub-4% overall cap rates in early 2022, it is also substantially below the average ~6% nominal cap rate observed today by Green Street for institutional-quality assets across the "four food group" property sectors.[5] This gap suggests that, despite recent writedowns, the valuations of core fund assets still appear too high.

Evaluating the universe of closed-end value-add and opportunistic real estate funds is more difficult, since these funds' assets are typically undergoing some type of repositioning, are not easily compared to one another, and are not reported on in a standardized format. However, one can glean from the very modest negative returns observed among these funds since 1Q 2022 (pooled average of less than -6%, after leverage and fees, through 3Q 2023)[6] that many closed-end fund sponsors have not written down the value of their assets as much as they probably should have.

Moreover, most private real estate funds use some amount of leverage, which magnifies the potential overhang in NAV. An asset that, for example, is still 10 – 20% overvalued on a gross basis and has 50% leverage (against yesterday's value) is facing a 20 – 40% impairment to NAV. It follows that many investors looking at the capital account statements of their private real estate fund holdings may want to do so with a large shaker of salt, if not a stiff drink.

[3] Green Street, Commercial Property Monthly, February 2, 2024.

[4] NCREIF, 4Q23 NPI press release.

[5] Green Street, Commercial Property Monthly, February 2, 2024. The weighted average is calculated using Green Street's observed nominal cap rates across Apartment, Industrial, Office and Retail (Mall/Strip Center) sectors, weighted by NCREIF's NPI sector breakdowns as of December 31, 2023.

[6] Burgiss data for the universe of value-add and opportunistic real estate funds, through September 30, 2023.

What's a Real Estate Secondary Buyer to Do?

From this data, one may conclude that buying real estate fund interests on the secondary market today, even at substantial discounts to current NAV, may not present an extraordinary opportunity.

Where this involves broadly diversified, highly levered real estate funds marked at yesterday's values, we would probably agree. However, we believe this view also paints the landscape with a very broad brush and risks missing many compelling individual opportunities that the current, prolonged period of illiquidity is creating in the real estate secondary market.

Indeed, we believe a focused strategy which targets performing assets in healthy sectors and avoids troubled funds, and which works creatively with motivated LPs and GPs searching for liquidity, can uncover situations offering very attractive entry pricing, leading to the potential for highly favorable risk-adjusted returns.

The key, in our view, is an intense focus on asset selection and fundamental analysis.

Not All Real Estate Assets (or NAVs) Are Created Equal

First off, when one looks beyond broad industry averages, it is clear that some real estate sectors are in better shape than others. Occupancies and rent growth may not be as eye-popping today as they were in late 2020 and 2021; nonetheless, still-favorable supply-demand fundamentals can be found in a number of asset classes, including most types of industrial property; many forms of for-rent residential (including single-family rental, student and manufactured housing); health care real estate (senior housing, medical office); tech real estate (data center, tower); certain types of lodging; and niche property types such as cold storage, marinas and lab space. Even some retail subsectors now exhibit solid occupancies and growth outlooks.

In these sectors, we believe it is possible to find assets whose values may not have fallen as far as industry averages might suggest, and/or where expectations of future income growth may not only justify current reported NAV, but could even support value appreciation in the near term.

Obviously, location matters as well. Property markets in different regions and geographies are often at different points in the cycle and may have structural characteristics which can influence future growth. A notable example today is the state of office markets in some European and Asian cities, where relatively low supply heading into the pandemic combined with a quick return-to-office culture have resulted in positive occupancy and rent trends, in sharp contrast to most cities in the U.S.

Second, of course, an individual asset in any sector may have unique characteristics that allow it to outperform the overall market. Understanding an asset's specific leasing situation, market and sub-market conditions, capital structure and exit path, for example, is critical to gaining comfort with that asset's true return potential, and can enable a real estate secondary buyer to capture value even when (or maybe because) broader market sentiment is negative.

Third, some private fund sponsors have been more aggressive in writing down values than others. Although, in our experience, most GPs are quick to recognize write-ups and slow to lower valuations, at any given point in time, the carrying values of certain funds will be more reasonable than for others.

In each of these circumstances, a relatively small nominal discount to a fund's current reported NAV could represent extraordinary value to a secondary buyer. One can even envision a scenario where a well-positioned real estate asset that is in a high-growth market and is valued conservatively by the GP might warrant little secondary discount at all (though don't hold your breath right now).

Focusing on Fundamentals

The key for secondary buyers is, therefore, being able to look past a GP's reported valuations and to perform one's own underwriting of a fund's underlying assets.

This means evaluating, among other things, what market rent and occupancy one believes is achievable in the coming years for a particular asset, what remaining holding period is likely, what exit cap rate the asset may command, and what levered and unlevered discount rate targets are appropriate for the corresponding risk.

A focus on capital structure is also imperative, especially given the state of capital markets today. Understanding the sustainability of underlying debt, and avoiding situations that could result in an extreme downside, must be a key focus of secondary investing.

Only once these elements have been determined across a fund's portfolio does it become possible to say whether the resulting entry price and implied discount to that fund's reported NAV present an attractive risk-return proposition.

Put another way: Is a 20% discount to GP NAV an attractive price at which to buy a particular fund interest? Maybe, maybe not. But is it attractive to buy a particular fund interest at a price that—after analysis of the underlying portfolio's reasonable return potential—implies a going-in cap rate (and corresponding levered and unlevered discount rates) above what's available via the direct transaction market for similar assets? That is easier to take a view on (Figure 4).

FIGURE 4: A 20% DISCOUNT UNDER TWO SCENARIOS: ONE INTERESTING, ONE LESS SO

	Hypothetical Multifamily Fund A Aggressive Valuation / Higher Leverage	Hypothetical Multifamily Fund B Less Aggressive Valuation / Lower Leverage
Forward NOI Projection	$4.50	$5.25
GP Valuation Cap Rate	4.50%	5.25%
GP Gross Asset Value (GAV)	$100	$100
Underlying Leverage	$55	$45
GP NAV	$45	$55
Secondary Discount	**20%**	**20%**
Secondary Purchase Price	$36	$44
Secondary Implied GAV	$91	$89
Secondary Implied Entry Cap Rate	**4.9%**	**5.9%**

Source: Neuberger Berman.

Two highly simplified secondary purchase examples assume that two funds own broadly similar portfolios and are bought at the same 20% discount to NAV. In the first scenario, a GP carrying value using a 4.5% cap rate, together with 55% fund leverage, results only in a projected 4.9% cap rate for the secondary buyer—not necessarily an interesting entry point in today's market. In the second scenario, a less aggressive 5.25% GP cap rate combined with lower (45%) leverage brings the secondary buyer's entry cap rate to 5.9%. Clearly, secondary discounts alone fail to tell the whole story.

Of course, this process requires the resources and skill set to perform a true bottom-up analysis of underlying fund assets, and not a top-down sector or GP-centric approach. Despite some people's perception, traditional LP secondaries can allow for such fundamental analysis, but it requires being selective and avoiding opaque situations—here, being a well-connected private market investor with strong GP relationships can often help. Buyers also should be wary of excessively large portfolios, where it may be difficult to perform a thorough evaluation of a sufficient number of underlying assets, and where idiosyncratic property characteristics are diversified away and risk becomes beta-like.

GP-led recapitalizations can often allow for such selectivity and look-through underwriting, which is one reason these types of transactions have appealed to many secondary players. At the same time, when bid-ask spreads in direct property markets are wide, like they are today, secondary investors need to be cautious they are not paying the same as (or more than) control buyers would for similar assets.

Finally, being an effective secondary buyer means having a healthy skepticism of GPs and their reporting. Despite best intentions, GPs don't have perfect information, and they can be blindsided by market movements like everyone else. We have also found that a historical GP track record is not always determinative in traditional secondary investing. Often, we have seen a best-in-class GP stuck with a challenged tail-end portfolio, or a GP with a mixed track record ending up with a fund owning a fantastic set of remaining assets. It all comes down to asset-level fundamental analysis on the part of the secondary buyer.

Waiting for the Bottom

The concern that discounts may not be sufficient today also carries an implication that investors should wait until real estate valuations fall further before considering secondaries. While this may seem like a prudent strategy, in practice we believe investors should be wary of trying to time the bottom of the market. On the contrary, we think it is precisely when sentiment is negative that well-positioned secondary buyers can find the most attractive opportunities. Once a bottom has become obvious and headlines start to turn positive, it is often already late to begin allocating.

This may mean investing when valuations could continue to fall in the short term. However, as long as one builds in a sufficient margin of safety and assets have a long enough runway, we believe successful investments can be made even in an environment of elevated valuations.

This also requires an emphasis on asset quality and resiliency. Capital structure is critical, of course, but today this means a redoubled focus on assets generating current cash flow and located in supply-constrained markets and sectors.

Remembering the basics of value-oriented investing is also imperative. While we cannot pretend to know when liquidity will fully return to real estate markets, it is still possible to get comfort that one is buying exposure to an asset at a discount to its true intrinsic value—for instance, at a price per square foot that is below any reasonable cost to replace that asset. Assuming sustainable leverage which has not put a timeclock on the investment, one can have strong conviction that such an acquisition will eventually be profitable, even if the time to realization may be less certain.

Conclusion

Investing during a period of dislocation and falling valuations can be uncomfortable, and we understand why some investors may be cautious to deploy capital in the commercial real estate sector today.

However, we believe real estate secondaries, when pursued well, are an excellent way to take advantage of the current environment. The lack of liquidity in real estate markets is forcing more and more LPs and GPs to consider an exit on the secondary market, a situation we think will continue and even accelerate in 2024 – 2025 as the direct property markets take more time to stabilize and fund managers slowly adjust NAVs to the new rate environment.

This presents the opportunity for well-positioned secondary buyers to gain exposure to quality assets for less than their true worth, i.e., classic value investing. By entering at an appropriately discounted basis and mitigating risks via careful asset selection, robust fundamental analysis, and disciplined and patient deployment, we believe real estate secondaries can provide investors a defensive way to generate outsized return in today's volatile real estate market.

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