Landmark Partners

Real estate secondaries: A strategy with defensive attributes

There is general sentiment among participants in real estate markets that we are at or are approaching a later stage of the current real estate market cycle. While overall global real estate fundamentals are generally healthy, and current real estate values can be supported when comparing real estate yields with their long-term relationship to fixed-income alternatives, property capital values, on an absolute basis, have generally fully recovered and in many core markets have materially exceeded their prior cyclical peak.

Investors remain attracted to private real estate for its relative value and risk/return attributes. Increasingly they are gravitating toward strategies with more defensive features. These include strategies where there is better protection in the capital stack and strategies that have strong income and cashflow qualities. In this environment, the real estate secondaries strategy has attracted growing interest from investors due to its own inherent defensive attributes, such as exposure to real estate assets at a discount to market value, accelerated distributions and hyper-diversification.

The real estate secondary market is generally believed to be seven to 10 years behind the private equity secondary market in terms of its evolution and overall market awareness. However, real estate investors' interest in real estate secondaries as a strategy has steadily increased over the years, as they have begun to recognise the strategy's attractive risk-adjusted return profile, defensive attributes and complementary benefits to other real estate fund investments in their portfolios.

The growth of the real estate secondary market

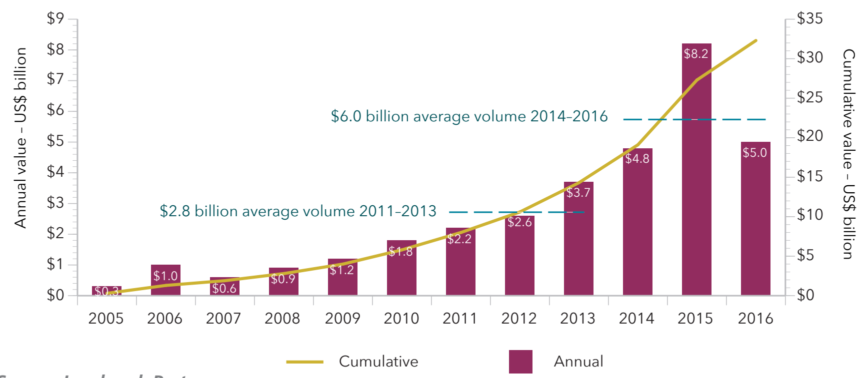
Real estate secondary transactions entail acquiring existing investor interests in private investment funds, separately managed accounts and other vehicles that hold private real estate. The first transactions in the real estate secondary market occurred in the mid-1990s. The real estate secondaries market has experienced significant growth over the past few years as an increasing number of investors have looked to more proactively manage their real estate fund portfolios to address allocation issues, reduce manager count, rebalance across strategies, create liquidity, harvest tax losses and address regulatory issues.

Overall, transaction dollar volume has grown 25 percent per year since 2008, as tracked by Landmark Partners. From 2014 to 2016, the market achieved an average of US$6 billion of transactions per year. This compares very favourably with the average of US$2.8 billion achieved over 2011 to 2013. This rapid growth has been very broad-based, with pension plans, endowments/foundations, asset managers, family offices, insurance companies, banks and funds of funds increasingly using the secondary market as an important portfolio management tool. A number of larger, high-profile transactions successfully completed over the past few years have helped to increase the visibility and validation of the secondary market. These US$1 billion-plus "mega" transactions can cause large fluctuations in annual transaction dollar volumes, as witnessed in 2015 when two large public pension funds traded portfolios in the secondaries market. This year, a US$2 billion portfolio was sold by a university endowment. Based on this and other activity to date, 2017 transaction volume is trending north of what was achieved in 2016.

Secondary transaction volume is a function of the amount of net asset value currently held across the universe of institutional real estate funds and the percentage of NAV that gets traded every year, a metric referred to as the "turnover ratio". The most recent three-year average real estate turnover ratio of 1.16 percent is beginning to approach the long-term average for private-equity funds. Despite high levels of distribution activity in recent years, peak vintage funds (pre-2009) continue to have substantial unrealised value. This and the resurgence in fundraising from 2013 to 2016 have driven the outstanding NAV of institutional closed-end real estate funds to record levels exceeding US$500 billion.

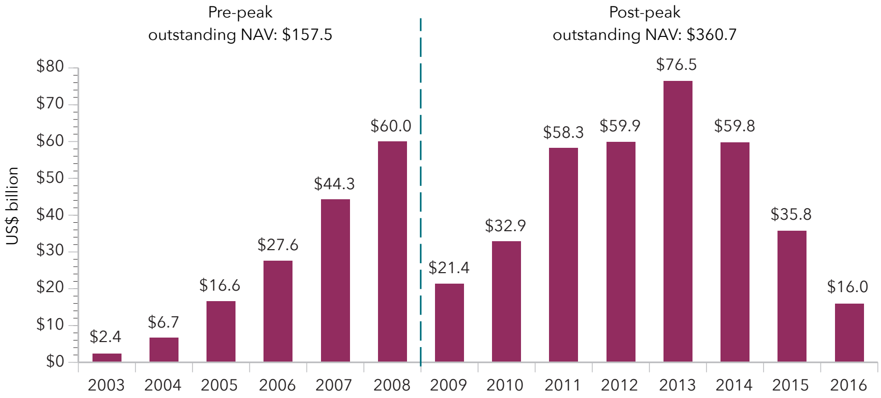
More than US$150 billion of NAV is held in funds that have reached and/or are close to reaching their legal expiry. We expect a significant amount of future deal flow to be generated from these funds due to investor fatigue and the overall administrative burden of managing these old partnerships. GP sponsor–led transactions, such as fund recapitalisations, have started to emerge to deal with these very mature funds, as both fund sponsors and LPs have begun to embrace the benefits of providing LPs with an avenue for liquidity. The real estate secondary market has also seen an increase in transaction volume from post-peak vintage funds (approximately US$360 billion of NAV outstanding), as LPs look to harvest gains and/or reduce exposure due to allocation issues or portfolio management shifts.

Global secondary market transaction volume



Source: Landmark Partners

Outstanding net asset values, post- and pre-peak



Sources: Preqin, Burgiss, Landmark Partners

Attributes of secondaries investment strategy

In general, investors have been attracted to secondaries because of its key attributes, including hyperdiversification, J-curve mitigation, accelerated distributions, exposure to seasoned assets, and the ability to acquire assets at a favourable cost basis. We believe these attributes can be even more valuable in today's real estate investment environment, as investors prioritise risk management and seek resilient strategies for their portfolios.

Diversification: A well-constructed real estate secondary portfolio exhibits reduced volatility, benefiting from exposure to hundreds and perhaps thousands of underlying property investments, diversified across all key metrics including vintage year, sponsor, strategy, sector and geographic area. In a typical real estate secondaries fund, the largest underlying single property investment may represent less than 2 percent to 3 percent of total NAV. This significantly reduces the impact that a single property's performance can have on the secondaries fund performance.

J-curve mitigation: Funds acquired in the secondary market are typically three to eight years old. Because many of these funds have well-seasoned portfolios, some of which are already in the harvesting stage, there is the ability to generate distributions almost immediately, minimising the impact of the J-curve that is more commonly experienced by primary funds due to the fee and expense load during the investment period and the early capital investment required to execute business plans.

Accelerated distribution: Very often, the more mature and "seasoned" funds that are acquired via secondary transactions are at a point in their lifecycles where they are generating income and disposition proceeds, leading to an accelerated distribution pattern as compared with primary funds. This results in faster return of capital and overall shorter duration for secondary funds. This shorter duration is especially valuable in today's investment environment, as it gives investors the ability to realise gains early and provides the most optionality for subsequent decision making (ie, reinvest in similar strategy, invest in different strategy, etc).

Exposure to seasoned assets: Buying seasoned funds via the secondary market also means investors are getting access to portfolios with lower risks than their labels would suggest. An opportunistic fund, for example, may have a 40 percent allocation to development projects. However, by the time a secondary investor acquires an interest in the fund in year 6, the fund's development projects no longer have permitting or construction risk and lease-up is already well progressed, if not already completed. The overall risk profile of the fund at this stage may be closer to core-plus or value-added than opportunistic.

Favourable pricing: The inefficiencies in the real estate secondary market provide good opportunities for experienced buyers to acquire fund interests at discounts to current value. Implicitly, acquiring exposure to underlying real estate assets at higher cap rates and at a lower basis than what is being achieved in the direct property markets provides some protection in the event of a market dislocation.

Conclusion

The real estate secondaries market has grown significantly in recent years, providing investors with both an important portfolio management tool and a strategy to gain exposure to private real estate on an attractive risk-adjusted basis. The defensive attributes of secondaries can provide for some level of durability during periods of uncertainty and market fluctuations. Going forward, secondary transaction volumes are anticipated to remain robust with strong prospects for continued growth, as an increasing number of LPs look to more proactively manage their real estate fund portfolios in the secondary market.

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CORPORATE OVERVIEW

Landmark Partners specialises in secondary market transactions of private equity, real estate and real assets investments, with approximately US$18.7 billion of committed capital as at 30 June 2017. Founded in 1989, the firm has one of the longest track records in the industry and is a leading source of liquidity to owners of interests in real estate, real asset, venture, mezzanine and buyout limited partnerships. Landmark Partners has more than 100 professionals across four offices in Boston, London, New York, and Simsbury, Connecticut.

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