BGO Strategic Capital Partners

The real estate secondaries market has matured to more than a liquidity solution

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Cherine Aboulzelof,** managing partner and co-head of BGO Strategic Capital Partners, about the outlook for the global real estate secondaries market. The following is an excerpt of that conversation.

How has the real estate secondaries market evolved during the past 10 years?

During the past decade, the real estate secondaries market has evolved from a burgeoning opportunity to a true cycle-tested investment strategy. Initially, the market was dominated by traditional limited partner secondaries. That market has matured significantly, and a more attractive approach today to secondary market investing has emerged, which is direct secondaries, or general partner leads. This strategy involves the recapitalization of assets and portfolios, as opposed to buying stakes in funds. This represents a natural evolution of the market as it became more sophisticated, mirroring, in a way, the evolution of the private equity secondary market.

How have the challenging market conditions of the past few years, such as conservative lending practices, upcoming loan maturities, valuation declines and depressed fundraising activity, affected the rise of the real estate secondaries market in recent years?

All these challenging market conditions you listed have affected most, if not all, fund sponsors. With elevated rates and less lending available, they may have needed to refire a loan on an asset. They may be experiencing valuation declines on their portfolio and haven't been able to raise enough capital. The larger firms have fared better, but small- and mid-cap fund sponsors that are seeking capital access, increasingly through the secondary market, have borne the brunt of these challenges.

The second trend we see emerging from these market conditions involves the investors or LPs in these funds playing a larger behind-the-scenes role, as they will be pressuring fund sponsors to sell assets to create liquidity and distribution in their own portfolios. These market conditions have already created, and will likely continue to create, attractive opportunities within the direct secondary space, as these fund sponsors are looking for a liquidity solution through secondary capital.

Through this process, there has been a lot of price discovery, with there being a significant pricing gap between buyers and sellers when it comes to asset prices. Now we're at a tipping point of the market because all the market conditions you mentioned are catalysts for the closed-end funds to sell some assets or recapitalize them with secondary capital, while waiting for more favorable market conditions.

How has the limited capital environment affected the selection of assets and portfolio construction in the secondaries markets? What are the opportunities for fund sponsors?

In this part of the cycle – the direct secondary format – we favor enhanced selectivity throughout the sector or relative to the asset, or even the sponsor exposure, we might want. This is in contrast to more traditional LP secondaries, where if you were buying a fund stake, you sometimes had to take the good along with the bad assets, all mixed in a single position.

Second, portfolio construction matters, especially in a global secondary strategy. We're a global player. In this limited capital environment, we like the ability to concentrate in specific demographic or niche technology-driven sectors that we believe are winning strategies. At the moment, we favor living sector investments and supply-chain management investments. And again, in this cycle, we believe those direct second-risk providers are the cleanest approach to constructing a preferred portfolio.

Within our strategy, we target the value-added and opportunistic small- and mid-cap fund sponsors – especially those sponsors with a first or second fund. They're specialists, and they're very good at what they do. They specialize in a geography and in a property sector, but they can't compete with the $5 billion or $30 billion fund. They view our type of secondary capital as a strategic partner. We've done repeat transactions with multifamily, vertically integrated sponsors with a good a track record, who want to invest more capital, but they're constrained. We come in with capital that is flexible, that we can invest into their portfolio, and we help them recapitalize assets, giving their portfolios growth equity. We speak the same language, and they really like that. These are exactly the types of sponsors we think we should be focusing on in this part of the cycle.

How has the volatile interest-rate environment affected the secondaries market? How will this change now?

In terms of the volatility, the high-interest-rate environment – the magnitude of the hikes and the uncertainty of the trajectory – contributed to the challenges we identified earlier. Transaction volumes are down from the peak level in 2022. In the United States, multifamily sales are down 60 percent, and in Europe, where I sit, even in the industrial sector – which is the darling of the capital markets – transactions have declined 50 percent. That liquidity crunch, along with interest-rate refinancing events induced by higher interest rates, have been the two major catalysts for direct secondary opportunities. Overlay on that the fundraising stress in this environment, and we have an ideal scenario where we can be that liquidity solution and enter into high-quality assets with specialist sponsors at this time in the cycle.

What are the challenges when navigating the global secondaries market? What are the nuances in the United States versus Europe versus Asia Pacific?

We invest globally within our secondary vehicles. The firm's current secondaries investing strategy keeps us overweight in the U.S. market, which is approximately 60 percent of the strategy. The second-largest allocation is in Europe at 30 percent to 40 percent, and then Asia Pacific is 15 percent to 20 percent. The United States is a massive market with more than 1,400 fund sponsors in 2023, and it represent two-thirds of the global institutional real estate market. From a secondary perspective, that is an enormous investment pipeline. It is the most liquid market in the world. The investment approach, however, varies quite a bit from market to market because there are specialists — integrated owner-operators, such as a Southeast multifamily manager, all the way to the large mega cap sponsor, and all the players in between. This abundance of sponsor choice results in difficulty for smaller and less experienced secondary investors, as one of the key successes in a secondary strategy is sponsor selection — understanding how these sponsors are positioned within each geography and how you can access the proprietary deal flow.

The sponsor landscape is quite different in Europe, where there is a high degree of concentration. Mid-to-large Pan-European sponsors based in London, which have regional teams or operating partners across the continent, comprise one source of deal flow. A second source for secondary investors is the spin-out of senior partners from those sponsors that have flourished during the past two or three years, who are now creating thematic or focused platforms. Finally, there are vertically integrated local sharpshooters with a specific country or sector focus — a Spain-focused fund, for example, or a Nordic fund or a European logistics fund. Access to these groups can be challenging because of cultural or operational barriers, including intricacies of tax and currency management. You need a real estate–centric team that understands the market nuances in a European market, which is typically more opaque than the United States on all fronts.

Asia Pacific is even more complex. Our team has been operating there since 2011 and has met with a very diverse and nuanced universe of sponsors. We have been focusing on fund sponsors with a single-market focus in Japan, Australia or South Korea. There are a number of barriers to entry in Asia, as well, that are difficult to navigate as secondary players, so identifying partners with a track record in this market is critical.

What is your outlook for the secondaries market during the next few years, especially as the commercial real estate market is expected to improve? Are there any interesting trends taking shape?

People often ask, "Is this a point-in-time opportunity? Or is this a strategy that is here to stay?" Just by sheer quantification of real estate secondary market volume, our view is that the market is definitely going to continue its growth trajectory.

Fund sponsors have become very astute. That's a key point about the evolution of the market — they understand now what the secondaries market capital can do for them. Their understanding and acceptance of that is a step change, and they will use that source the same way they use the primary fundraising capital to fund their deals. It will become more of a permanent strategy of raising capital for them. Typically, they don't care if the transaction is a secondary or not. They just want to fund their deals.

On the investor side, investing in secondary funds and in secondary strategies will increasingly become a part of portfolio construction because of the attractiveness of short-duration deals and access to direct assets, and it is another way to complement holes in their portfolios. In either a direct secondary or a traditional secondary, the overriding objective is liquidity. Capital comes back faster. This is becoming a portfolio construction tool for institutional investors.

How is BGO's approach to the secondaries market distinct?

First, we have a direct real estate strategy investing in assets with fund sponsors because that gives us control over the portfolio. We typically invest to gain a meaningful portion of any given deal and to have a seat at the table with the sponsor for making major decisions. We also like this direct real estate approach because our focus is very much on the value-added inflection point of a business plan. For example, in a five-year business plan, we come in at year two of a business plan, where value creation is already under way. In this case, we make money on net operating income [NOI] growth rather than the capital markets arbitrage. That is one of the key features of our direct strategy.

A second distinction is that we focus on this underserved and undercapitalized market segment of the small- and mid-cap sponsors who generally have outperformed by about 400 basis points. With deal sizes that are typically under the $75 million range, we are able to focus on bilateral deals with the fund sponsors.

Finally, a third differentiation is having a true global team with decades of boots-on-the-ground experience. Our team members, whether in the United States, Europe or Asia, have been on the direct side of this business for decades prior to being in the secondary space. That creates the network needed for consistent deal flow with the small- and mid-cap sponsors. It just doesn't happen overnight.

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Cherine Aboulzelof is a managing partner and co-head of BGO Strategic Capital Partners, based in London. With more than 20 years of experience in real estate investing, she co-leads the investment strategy for SCP, is responsible for investments in Europe and is a member of SCP's global investment committee. Aboulzelof held similar responsibilities with Metropolitan Real Estate Equity Management, wholly owned by The Carlyle Group, prior to it merging with BGO in April 2021. She started her career in investment banking at Goldman Sachs and Morgan Stanley. Aboulzelof is a member of the GRI Europe Women Leading Real Estate Advisory Board and a board member of WIRE (Women in Real Estate) in Europe. She also sits on the Steering Committee of Menorca Preservation.

COMPANY OVERVIEW

BGO Strategic Capital Partners is a market-leading, global multi-manager platform. Founded in 2002, BGO SCP has raised approximately $6.3 billion in aggregate capital commitments, establishing decades of experience as a leading real estate multi-manager investor. Our focus includes direct secondary investments and co-investments, along with the creation of tailored portfolios investing across strategies on behalf of separately managed account clients..

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