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Secondaries & Recapitalizations

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KEYNOTE INTERVIEW

Real estate secondaries going mainstream

CBRE IM's Kilian Toms and Chris Dickson outline where the real estate secondaries market is at today and where it is heading tomorrow

CBRE Investment Management has around $147.5 billion in assets under management as of year-end 2023. Through its investor-operator culture, the firm delivers sustainable investment solutions across real assets categories, geographies, risk profiles and execution formats.

CBRE IM Indirect has a circa $12 billion track record spanning 15 years of executing secondaries transactions across risk profiles within its commingled funds and separate account products.

The platform is a six-time winner of *PERE*'s Indirect Firm of the Year: Global award.

Kilian Toms, a fund manager and managing director of CBRE IM's Real Estate Partners strategy, is based in London and responsible for all aspects of the strategy, which focuses on enhanced return secondary market executions.

He is supported by a global secondary portfolio management team that includes Chris Dickson, deputy fund manager and senior director of the real estate partners strategy in Boston, Massachusetts, who has been with CBRE IM Indirect for 10 years focusing on secondaries investment.

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Q What is happening in the secondaries market right now?

Chris Dickson: The secondary market is very different pre- and post-pandemic. Before the pandemic, it was largely an LP-led market, whereas now it is the GP-led opportunities that represent the majority of transactions. What this does is bring real estate secondaries closer to the real estate sector, where operational expertise is needed to assess opportunities.

Pricing remains a challenge. The discount is obviously the key factor in the secondaries market, and we have to recognize that, in a world where net asset values have been so far off our view of intrinsic value, the discount can be well wide of a seller's expectations. We are starting to see the bid-ask gap close, particularly in our preferred sectors: industrial and residential.

Kilian Toms: It is true that the bid-ask spread for secondary transactions in our preferred sectors is coming down, but that is ongoing. Private equity real estate valuations in general are still adjusting downwards as comparable transactions in the direct market provide more transparency. This adjustment is a key component we are tracking and is particularly meaningful in the United States and in Europe, while in Asia there is less of a problem.

Valuation is very important and the uncertainty around real estate valuations, with prices still coming down, makes the market attractive for secondaries investors. Essentially, the discount via secondaries allows us to buy real estate today, at tomorrow's price. And we are very cognizant of the fact that historically, the best investment vintage opportunities have come when valuations trough.

Q What are the main catalysts for activity in the market?

CD: Generally speaking, you need three ingredients for a strong secondaries market. Volatility, price correction and duration.

During covid, we had the first two, but we did not have these factors in play for a long enough duration to become a significant catalyst for transactions. Today that is happening, as we have entered an extremely volatile period where prices have been correcting for 12-24 months. Both the debt and equity capital markets have remained illiquid and the pain that is causing has accelerated. Many sellers that saw liquidity as "nice to have" in 2023 are finding liquidity has become a necessity.

KT: Another big catalyst is when investors are restructuring their businesses or shifting strategies. The denominator effect – that is the unintentional overweight to private assets caused by declining public market valuations – has largely played out, but there all still groups that are rebalancing their portfolios and using the secondaries market to do it.

The high number of transaction opportunities also relates to the number of operators or developers, rather than fund sponsors, that have real estate on their balance sheets and need to generate liquidity.

By selling a portion of their positions, they can do that. In all these cases, we are involved in the market and like to position ourselves as a thought partner.

Q Is the market changing?

KT: I think you have to separate the cyclical drivers from the secular drivers. Utilization of secondaries is increasing both for GPs and LPs because the secondary market has become a tool to manage portfolios and generate liquidity.

I fundamentally think secondary transactions are an integral part of the entire real estate market, and the opportunities we have are unique because some of the best privately owned portfolios may never hit the direct transaction market again – fund and portfolio recapitalizations are becoming a deliberate strategy for GPs who want to retain control of their best assets. So, in addition to diversification and risk management, we are able to offer our investors an opportunity to invest in some of the most important assets in real estate globally.

The market growth that we are seeing in the sector now is therefore not just cyclical but is actually secular – and that is going to continue to power growth.

Q Where are the opportunities now?

KT: In sector terms, we see a real bifurcation between those that are relevant and those that we need to avoid.

There have been important sector themes in the past 10 years. But if you failed in your sector selection as a secondary investor, to some extent, you would have been bailed out by the discounted transaction price, a liquid market and rising values. Now, sectors are becoming less correlated, and we are seeing that avoiding the wrong sectors has become much more important.

CD: We have a top-down approach to portfolio construction, so sector selection is a crucial tool to help us generate strong returns and mitigate risk. We seek to avoid certain sectors where we see outsized pricing risk on entry or liquidity risk on exit.

One common misconception about secondaries is that you end up just buying inferior assets in markets others avoid or sectors that are not favorable. That is simply not the case; we have had success exclusively targeting investments in our preferred sectors in markets we believe will outperform. That is where we see the opportunity today.

The risks of straying outside of a top-down investment strategy are highlighted by what is going on with the office sector at the moment. It is very hard to understand the underlying fundamentals there and difficult to build confidence in any underwriting proposal, particularly in the US but also in Europe. The result is a sector where the risk-return trade has a negative skew. Asia is an exception to this, but I am still concerned that there may be contagion risk even in those markets from the negative sentiment about offices globally.

"The secondaries market is moving away from being a niche activity to becoming a core part of global real estate portfolios"

KILIAN TOMS

Q Looking ahead, is that likely to change?

CD: From a top-down prospective, I do not think so. The structural trends that underpin the fundamentals in our preferred sectors evolve over years, not months. I am sure there will be some change on the margin, but our belief that industrial and residential strategies are well positioned to outperform is here to stay. What does change more frequently is our asset selection within these target sectors.

KT: Accessing high-quality real estate, at a discount, will continue to be key to our strategy – but we need to understand, discount to what? Looking ahead, we are focusing on opportunities where we can underwrite the operating fundamentals of the underlying assets in clear detail. We know that occupiers, capital markets and debt providers are all going to be more discerning about the assets across all property types. And for those that just don't have those credentials, liquidity, valuations and occupancy will be highly at risk.

Q How should investors focus on individual asset selection, then?

CD: This is one way that our parentage really matters, being part of CBRE IM and the larger CBRE allows us to approach secondaries from the prospective of an operator. Having this expertise across the organization is critical to the way we execute since it allows us to get very granular in our asset selection. Rather than focusing on portfolio-level metrics and financials in our underwriting, we are happy to underwrite in much the same way as our direct counterparts, down to the lease level or looking neighborhood by neighborhood. It is through this process where we build conviction around certain opportunities and separate the winners and losers.

KT: We are a global player with boots on the ground almost everywhere, which gives us incredible access to transactions. We really look at secondaries as just another way to acquire the real estate we want to get into anyway.

Q What about the future of real estate secondaries?

KT: There is a lot of fog around the size of the market and how much is transacting. The growth in transaction volumes is massively under-reported. The amount happening is not reflected in the traditional data sources. We should not lose sight of the fact that the transactions happening in core portfolios are quite enormous and the information associated with bilateral transactions is largely uncaptured; they should be included in the figures going forward. These factors combined represent a market that is too huge to ignore.

This also means the direction of travel is clear. The secondaries market is moving away from being a niche activity to becoming a core part of global real estate portfolios. This is just the beginning.

CD: As the market continues to mature, investors are accepting secondaries are a necessary tool in the toolbox to manage portfolios in an illiquid asset class. Our business has been active on the buy- and sellside for the last 15 years and have found the liquidity the secondary market often provides a superior execution for our clients. The next step in growth in the market will be when this concept is more broadly accepted – and that will come. ■