RPM Ep 38 transcript

Maribel Yoo: [00:00:00] Welcome to RPM, the podcast that explores the world of private markets. I'm your host, Maribel Yoo. On this episode, we'll be revisiting key themes from a recent whitepaper we published titled "Bull Market for Real Estate Secondaries." Once again, I'd like to welcome back two members of StepStone real estate team Jeff Giller, Partner and Global Head of StepStone Real Estate, and Margaret McKnight, Partner and Head of Portfolio Solutions for SRE. You both have previously joined me to discuss the state of the real estate market, but in this episode, we'll take a closer look at the appealing characteristics of today's real estate secondaries market, as well as the ongoing role secondaries plays. It'll be great to also hear how you define the two different forms of secondaries – GP-Led and LP-Led. You two are seasoned pros by now with or without the mic, so I'll let you two take it from here. This time it looks like Jeff, you're in the hot seat with Margaret guiding today's discussion.

Margaret McKnight: [00:00:47] Thanks, Maribel. Yes, I get to ask the questions today. So, Jeff, I think the second time you and I crossed paths back in the day, your team was pioneering some of the first ever secondaries among real estate funds. And I was at another consultant. You guys were asking about potential investor interest. Sound familiar? I think we still have the same essential job descriptions. Anyway, the two of us have been in the secondaries business since it started, and I've seen quite a bit of evolution. Before we get into that evolution, I have to ask about the title of the white paper with all the perspective you have, why do you think now is special? Why do you see a bull market for secondaries?

Jeff Giller: [00:01:29] Thanks, Margaret. It's always good to be talking to you, whether it's mic'd up on a podcast or just in the office talking about investment strategy.

Margaret, this is a bull market for real estate secondaries because secondaries' role is to provide liquidity to real estate funds and other kinds of real estate vehicles and limited partners in those vehicles. Right now, the market is exceptionally liquidity constrained because values have dropped following rising interest rates and sellers aren't willing to sell at the current market pricing so transaction volume has pretty much ceased in the market. Therefore, there aren't distributions going to LPs. So they've become liquidity constrained, since they're not getting distributions.

At the same time, debts coming due in funds and other real estate vehicles and the amount of refinancing proceeds that are calculated off higher interest rates are lower than loan payoff amounts. So GPs need liquidity to help pay down existing principal balances.

what's really interesting about this time, and why it's an attractive buying opportunity is because unlike in the post-GFC period, there's not operational distress in the assets. The recession that everybody thought was coming has yet to emerge. And property fundamentals are actually very strong. Rents keep rising, occupancy levels are high and we just don't see the kind of distress we had in the post-GFC era. So the issues are all capital markets related and capital structure related. if you can solve the capital structure issue through a GP-Led secondary, then you've derisked the investment at the time you close and don't necessarily have to live with operational distress in the in the asset afterwards. So it's really attractive environment to be investing in secondaries.

MM: [00:03:30] So the flow is starting right. You're starting to see at least a trickle of transactions that are pricing at what are likely to be similar to the post-GFC levels.

JG: [00:03:41] You know, it's just starting. We're just starting to see market activity. In the GP market, as I'd mentioned, the need to pull in liquidity to address funding gaps with maturing debt happens as debt

matures. And even after the debt matures, there's always a dance to go through between the lender and the manager to work out the property and to maybe buy more time. And then once they get to a point where they'll negotiate a payoff amount and maybe go through extended timing and the GPs to line up refinancing, then there would be an opportunity for GP-Led secondaries investors to come in and provide capital to the funding gap, but that really occurs at the time and after debt matures, and we've seen in 2023 as kind of the beginning of a big wave of maturing debt.
we're starting to see transactions in the GP market pick up. We've also seen transactions where GPs say that are developers and are used to recycling their capital into new projects, can't sell their properties so their development programs have stopped. So there's been an opportunity to go in and to invest or recapitalize their existing positions in their assets, and then they can use the proceeds to continue to continue their development program. So we're starting to see it on the GP side.

MM: [00:05:07] our recent House Views publication goes over all the math of the funding gap and the cash in refinancing that many GPs are facing, it gives a lot more detail on this for anybody who'd like more information. Speaking of the House Views, Jeff, how does the House Views work that we do inform which secondary investments are interesting?

JG: [00:05:26] one of the fundamental features of the secondary market is you often have to be asset takers, especially if you're investing in LP secondaries where an institution may decide to sell interest in a basket of funds they hold and you sort of get what you get if you win the auction to buy those LP interests. So you end up with maybe a diversified basket of assets. It's very hard to exercise the kind of portfolio construction that we like. That's a fundamental part of our advisory business and which you oversee has had a portfolio of solutions, as you know.

So in GP-led secondaries, at least the way we're able to execute them, we can really target certain product sectors, geographies and different types of capital structures because we're mainly looking at sector specific funds and we've been able to construct portfolios of the products we like that have been informed by the House Views that we put together and in our prior funds

MM: [00:08:47] So secondaries enables you to solve GP problems, enter at an attractive price in the sectors that are promising. And we have selectivity and can shift according to the house views to the more interesting things in the market opportunities. Could we talk a little bit about definitions to make sure we're all on the same page. And this is where we get into the market evolution, because that first deal we looked at some 20 years ago was being sold by an LP, so an LP-led secondary, and now you're talking about working with GPs. Can you tell us about the two different ways of doing secondaries? And probably a lot more, but how they compare?

JG: [00:09:28] Yeah. Look, we as you know, we started off focused on LP-led secondaries back in the 2005 to the period to the GFC. And what we found about the LPs secondary market is it's almost always auctioned, so you're it's a very competitive market that you're buying the interest from the LPs and you're owning that interest, and that transfer does nothing for the GP. So they either can't or won't spend the time to help you understand the assets and give you the data. And then once you made the acquisition, you own a minority, non-controlling position in a fund. what we found during the GFC, is that that opacity, not really knowing what you owned and not having any control when things go bad and not all GPs always do what's in the best interest of their investors during those periods, that we started looking for a better way to approach the market.
So having had a direct real estate background for 25 years of my career prior to entering the secondary market, I was really focused on figuring out how to take the best of direct investing and more indirect

secondary investing, and we were exposed to a lot of funds that needed recapitalizing during the GFC for the reasons I gave earlier, because their debt was maturing and they needed to pay it down and deal with funding gaps.

our objective was always to get access to existing seasoned assets at discounts to their fair market value. And we determined we could do that by recapitalizing funds, but if you're working with the GP instead of the LP and the transaction's important to the GP, then you can push to get all the information you need so you can underwrite the assets in the funds as if you were buying individual assets, so you get rent rolls, operating statements, debt documents. You can do due diligence on the manager, if you're buying the position from from the LP, you never get any of that information. It just doesn't happen.

The other thing we decided we wanted was control. So we set up our GP-led secondary deals, recaps and other types to have control positions really like joint venture, like control or at least major decision rights so we could control our destiny and our exit.

And the other aspect of GP leds and LP leds that are different is, is that GP leads tend to be less competitive. We bought very few of our GP-led deals in auctions. It's because the GP is really more focused on who the partner is and what the profile of the partner is in a GP-led investment, because you're basically living with them, helping them work through their issues with your capital and in an LP-led, you're just a substitute limited partner. That means nothing to the GP, so the LP will sell to whoever pays the highest price. The GP will often work with whoever the best partner is, so that's why you get more information you can negotiate for control, and these things tend to be done more so off market and not through auctions.

MM: [00:13:14] And then it's turned out right that the LP leds are pretty episodic. There was a moment in the market where fundamentals are rising, and the underlying investment has enough lift that the buyer doesn't need a lot of discount, so it's palatable to boards and they will sell. But otherwise, the volumes kind of dried up. And that has been a problem for investors solely focused on that. GP leds are not episodic right, so they have an ongoing kind of evergreen problem solving role for GPs, right.

JG: [00:13:46] Yeah, you really hit the nail on the head, Margaret. The LP market really hasn't come to fruition yet in this phase of the cycle, because property values have not been adequately written down by managers at this point. I think it's conventional wisdom that most funds and real estate vehicles are over marked relative to the liquidation values of the assets today. So a secondaries buyer is going to price the assets at where they think the market value is today. And that's turned out to be too extreme a discount for LPs to sell. we've seen a lot of LPs bring portfolios to market to try to sell, and the bids are getting are 25%, 30% or higher discounts to their market value, and they just can't take those kind of discounts to their boards and succeed. So marks have to come down significantly before a functioning LP secondary market kicks in.

With respect to GP leds, you know they happen earlier because as I said as I said previously the GPs are trying to deal with their maturing debt as it arises. Lenders are largely out of the market right now, so getting loans is difficult enough, but if they get them, they're going to be underwritten on a very conservative basis with lower debt service coverage ratios, lower loan-to-value ratios, and cap rates have increased along with increasing interest rates. the loan sizes are just going to be much smaller. So the GPs are going to need to seek a recapitalization to bring in new capital in order to fund the gap between their current loan payoff amounts and the new refi proceeds they can pick up. So that's really catalyzed the GP-led secondary market.

And so transactions are starting to occur, as I said earlier, the debt has to mature first. There's probably a workout period between the bar and the lender. And then the borrower seeks the GP-led secondary solution. But to your point, GP-led secondaries don't just happen during downturns where there's funding gaps and illiquidity.

We started our GP-led secondary program post-GFC, really dealing with the liquidity and funding gaps and as the market matured, we found all kinds of other needs that we had for our capital. One was continuation vehicles. Funds would get to the end of their life. Some of the remaining assets might still have some value creation potential. The GPs would want to continue with the assets and take them to the next level. The LPs were seeking liquidity. The LPs had done well so we could come in and buy their positions, or basically buy out all their positions and take over the fund at a discount to fair market value, and the LPs would have still achieved attractive returns. Then we work with the GP to reset their carry and economics to our new basis and take the assets to the next level.
The other reason why GPs sought our capital for GP-led secondaries in the more mature market environment that kind of happened between 2015 and 2020, is because of the increased concentration of LP capital into the mega name brand funds, so something like 50% of all the capital raised in the market in the last few years has gone to the top ten managers, leaving a lot of very good small and medium-sized managers out of the market. we've seen these great managers having failed fundraisers or fundraisers that never got off the ground but they own strong existing portfolios. So we could go in and we could recapitalize those existing portfolios, and they could use the proceeds to continue their investment programs and oftentimes will add additional capital that we control. we make the investment decisions along with them so they can expand their portfolios. So that became a really strong catalyst for GP-led secondaries in the more mature market environments.

MM: [00:18:14] So GP-led secondaries tend to be highly structured, negotiated transactions that can solve a variety of problems for GPs over time. there's clearly a volume of GP leds, and we're at the leading edge of a really interesting period because they solve two problems. They fixed the GPs funding gap, which allows them to retain promising assets through to better days, and they enable LPs to get desired liquidity. So this gap capital is valuable and scarce, which is increasingly being demonstrated by attractive pricing and structuring with downside protection. And again, the problem is coming from the capital markets, the jump in interest rates, not the fundamentals. So GP leds can provide access on very favorable terms to assets with attractive outlook. All in all, conditions are favorable for a bull market in real estate secondaries. If you'd like more information, including copies of our secondaries white paper or our House Views, please reach out to us at SREmarketresearch@stepstonegroup.com. That's SRE as in Stepstone Real Estate. Thanks, Jeff. Always a pleasure and thanks to our audience for listening.

JG: [00:20:02] Thanks, Margaret. I really enjoyed the conversation.

MY: [00:20:05] Great discussion on how secondaries can provide much needed liquidity to real estate managers and their investors, in this liquidity-constrained environment. Thank you both for joining me on this episode at RPM. Visit us at www.stepstonegroup.com. RPM is available on Apple Podcasts, Spotify, Stitcher, and other podcast platforms.