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Spring 2024 Real Estate House Views with Jeff Giller and Margaret McKnight

Maribel Yoo: [00:00:02] Welcome to RPM! On today's episode, we'll be discussing our Spring 2024 Real Estate House Views. As background, StepStone Real Estate house views are developed from a top down and bottom-up approach that combines macroeconomic, demographic and geopolitical factors analyzed by our market research team in combination with the on the ground insights of our investment team. Our investment team's input is largely informed by our experience having allocated an average of approximately 15 billion per year over the last three years into real estate funds, secondaries, recapitalizations and co-investments. Not to mention our team had the opportunity to meet with over 970 real estate GPs in 2023 alone. Now for an outlook on the real estate market, I'd like to hand this episode over to our guests. I'm excited to welcome back Jeff Giller, Partner and Head of StepStone Real Estate, and Margaret McKnight, Partner and Head of Portfolio Solutions for SRE. Both Jeff and Margaret are based in San Francisco and will be joining me to guide today's discussion.

Jeff Giller: [00:01:02] Thanks, Maribel. Margaret, this continues to be a very interesting market and I'm really looking forward to our conversation. On our last podcast in November, we talked about a real estate environment full of both challenges and opportunities, and we listed key questions facing real estate investors, namely one, With the built environment changing before our very eyes and a significant stock of functionally obsolete buildings in every asset category, what real estate asset types should we be investing in? And two, with reported values still high relative to actual market clearing prices, when is the right time to start putting capital into the market? Six months later, these still seem to be the main questions. So my question for you is have the answers to the questions changed?

Margaret McKnight: [00:01:40] Hello everyone. Thanks for listening. And they've evolved, so let's answer them in the reverse order starting with the value question because really the dominant factor this cycle is capital markets and price changes in the wake of sharply higher interest rates. So the short answer to when to start investing is really now for non-core. Were at the leading edge of what has the potential to be the best buying opportunity in 15 years for re-caps and distress. So exciting times. And then for open ended funds or generally things traded based on appraisal value, the answer is not yet, and not until the appraised values get closer to the reality of today's interest and cap rates. Different from our last conversation, it's

now pretty clear that property trading prices really do reflect the realities of today's market conditions, and so that includes interest rates that are likely to stay higher for longer in the US, with a solid but softening economy and then likely lower rates ahead in Europe amid much softer economies.

JG: [00:02:40] So why now for recaps and distress?

MM: [00:02:43] So with borrowing rates nearly doubled, maturing debt and floating rate debt pose real challenges, especially for owners with higher leverage. And we've been talking about this for a while. New loans are hard to get. Usually your best deal is with your existing lender, and they're requiring you to put cash in to keep the assets. And often a lot of cash. Higher rates means that properties can support roughly half the debt they used to at the ratios lenders are comfortable with. So this is the same situation six months along, but now with less reason to believe that US rates are going to drop and save the day for everyone. Stress is building on roughly 3 trillion of maturities in US and Europe in the '23 to '26 time frame, and we keep '23 in there because a lot of it's not worked out. Estimates are that about 375 million of the '23 maturities got extended mostly into 2024. So, it's a very big problem. We saw the same kind of a big problem in the post-GFC period. There's a lot of data and it's in our house views or some of it is, that points to the problem, the fact that these kinds of big problems turn into widespread opportunity about 2 or 3 years after the crisis. So, Jeff, while you and I could happily spend all day comparing the post-GFC period to now, the real driver on timing is ultimately how long it takes to work out loans.

[00:04:06] And that's not as variable. There are more and less defined processes depending on the nature of the lenders. There are very strong vested interests on both sides. Plus, staffing issues, workouts take a lot of bandwidth. Many of these situations are very complex, and all of this adds up to taking real time to sort problems. And like the 2 to 3 years, we're talking about, to see the distress flow. So, if we map that timeline onto the current cycle, which started call it early to mid-second quarter 2022, that would imply that this cycle, the opportunities are going to be ramping up later in ‘24 and into ‘25. The GFC was catalyzed by the failure of Bear and Lehman in 2008, and the peak non-core vintage year was 2010. There was very good opportunity from 2010 to ‘12, but the average fund return was the highest in 2010, so you had the highest probability of picking a winner if you entered early. The high end, the upper quartile of funds, stayed high through those three years, which also emphasizes the importance of investing

resources to select and diligence high quality managers with demonstrated skills at both accessing and unlocking distressed potential. And that's something that we at StepStone and our manager research team works on a lot. So again, conditions are very exciting but also challenging. So you need to be thoughtful about how you approach them.

JG: [00:05:32] I agree that there should be great buying opportunities ahead, but of course you need to start with property owners who are willing to sell at distressed pricing, which is not as of yet been occurring. I'm hearing all over the transaction volume is ramping up, but you're telling me it's not. What's going on?

MM: [00:05:47] So the short version is that bad news on the inflation front means rates are not coming down soon in the US. And that is backing up trading, especially voluntary trading. What I was talking about a minute ago is really involuntary trading and more a function of that work-out process. So, ‘23 volume was a third below the post-GFC average in the US, and it was down by half in Europe. The first quarter of ‘24 is not starting off well. Volume was about 15% below the first quarter of ‘23. On the plus side, it's above the worst quarter of lockdown. You can't really annualize this because trading is seasonal, usually with a big pop in the fourth quarter. We did start to have that strong fourth quarter in the US, but then the fed announced in October it wouldn't be lowering rates in ‘23, so that volume just completely fizzled. And this reminds us that rates are the big problem. High rates ultimately push prices down. And so far about 25% in the US and Europe. If you don't have to sell, why take that hit? Owners haven’t capitulated and won’t until they have to, which is why the distress and loan workout situation matters so much to volume.

[00:06:56] And of course, that’s average. The actual loss varies by the size and the type of the asset. So, we're hearing for sure about deeper bidding pools. But it turns out those tend to involve robust high net worth activity more than institutional activity. And for both groups really, volume is still highly concentrated in smaller industrial and multifamily assets, as is lender activity. So, the lack of debt capital is another issue, with lenders really sidelined on the work-outs. But there are some green shoots. Investor interest in CMBS paper is rising. Snd so that is helping. And it's especially making it possible to do big deals, like a half a billion and up. So, we’re starting to see a few of those. And then the lack of investor capital is the other issue. Among other things, the core funds are not buying. At a higher level, we also know that investors

are not deploying in mass, certainly not to core funds, but also non-core fundraising is way down.

JG: [00:07:52] Bigger picture, the stock market is rebounded. So, there isn't a denominator effect anymore. Why aren't investors deploying capital? It seems as though a number of investors want to see the new opportunity proven out before they're willing to commit to funds. But as you've pointed out, waiting could mean they miss deploying capital in the best vintages. If you're waiting to see a lot of done deals to see them in the rearview mirror, you may have missed the best opportunity.

MM: [00:08:16] Yeah, and that definitely happened in the post-GFC period. I think investors did learn from that, and they are at least somewhat more likely to place their bets before the dice land. And there's some other factors at work. One is that investors have a lot of outstanding, uncalled commitment. Our data says that capital calls are running at only 69% of normal, and Preqin shows near-peak levels of dry powder, though it did go down 15% last year. Side note, for funds that straddle the correction, a lot of that dry powder is going to go to defend the pre-correction acquisitions and not into new buys. That could still be interesting. It's just important to understand your actual exposures. The other factor is investors are not getting money back to recommit. Distributions are running about 25% of normal according to our data. Investors are trying to get money out of their core portfolios. And so there we see redemption cues that are running 17% of total outstanding in the US. But it's not yielding much because the managers are gating and not paying out. With the denominator effect gone, you're right about that, investors are likely still in these cues because they're seeking funds to capitalize on the appealing non-core situation. But, maybe even more so because it's just a good trade. US fund NAVs (net asset values) are more than 10% above the fair market value of the properties. If the fund managers properly marked to market those cues, those exit cues would likely disappear. We've actually seen that, it just happened in Europe and it happened last cycle. Plus, that could cause investors to drop to being meaningfully under allocated. Even more so, if the noncore fund NAVs match the trading prices and then core funds would get inflows and could buy again, thus solving, the trading volume issue. So, these valuations really do matter.

JG: [00:10:03] So what about property type? What do we like and what do we not like so much?

MM: [00:10:08] So it's still office and everything else, which is exactly what we said last time. In the current house views, we removed the five-year projections for office returns because there's simply not enough transparency on fundamentals. There's no reliable exit market or acquisition debt. Pretty dramatic statement, right? The market, the actual leasing market is settling out to the top 15%, give or take, of office buildings that have the things that tenants want today and they're leasing well, but with no capital market support. And it's not clear that there's any real case for sustained rental growth in this category. At the other end, at the bottom, call it 30% or so of buildings are functionally obsolete and need to be something that's not office. Most often that involves a tear down so it's disastrous for value. And then there's everything in the middle that needs to get worked out in an environment where tenants are generally renewing, but into smaller spaces. And both CapEx and debt pose big problems. So, better capitalized deals are going to have a real advantage, and the number of deals that fit that category will gradually tick up as distressed trades at bargain basement prices happen. The issue is those best prices are not going to be on the best assets. So, the opportunity is really not as interesting as it might seem. Everything else continues to have a decent mid-term outlook to the extent it benefits from the changing use of space that we talked about last time.

[00:11:42] And, in the short term, a lot of assets are feeling the pressures of weaker economies, somewhat not disastrous. Industrial is still the most promising of the major property types. Demand is slowing, with higher correlation to softer retail sales and larger tenants being cautious and slower to lease, so rental rate growth is flattening out. But this is not expected to last long due to really supportive secular trends, plus a shorter construction cycle, which means a faster supply adjustment. And then data centers are the darlings of the niche sectors with strong AI related demand, meaning really substantial supply constraints with respect to the availability of powered land. There are many more interesting sectors noted in our House Views. And the property type discussion is all with the overlay of the bigger points I've been making. The distressed buying opportunity means a chance to get assets with decent to good outlooks at prices that reflect capital markets dislocation. So, we're switching into a period where selection should be more bottom up. It's no longer as simple as picking the right property type and backing up the truck. Thank you. industrial. It's more about picking the right transaction, which means picking managers who are good at sourcing and capitalizing on distress. And that is what we at StepStone love to work with our clients every day. And again, we're very excited about the potential of today's market conditions.

MY: [00:13:08] Thanks, Margaret. Another insightful discussion on the state of the real estate market. I appreciate you both taking the time to join me today.

JG: [00:13:14] Thanks, Maribel.

MM: [00:13:21] I am too, and I really appreciate everyone listening.

MY: [00:13:26] Thanks again for listening. If you're interested in the full Spring 2024 House Views report, you can visit our website, stepstonegroup.com. Additionally, you can reach out to a member of our real estate team for a replay of the House Views webinar or any other information. As a reminder, RPM is available on Apple Podcasts, Spotify, Stitcher and other podcast platforms.