Real Estate House Views ft. Jeff Giller and Margaret McKnight

MY: [00:00:00] Welcome to the podcast that explores the world of private markets. I'm your host, Maribel Yoo. On this episode we'll be discussing our Spring 2023 Real Estate House Views. This covers the state of the markets, leveraging the Stepstone Real Estate team's daily global interactions with various market participants. The scope of these activities includes over 900 meetings with GPs research to deploy $18 Billion in primary fund commitments along with our clients, as well as transaction level underwriting leading to $2 billion of secondaries and co-investments, all of which occurred in 2022, in addition to our analysis of data and third party research. Joining me to guide today's discussion is Jeff Giller, Partner and Head of Real Estate, and Margaret McKnight, Partner and Head of Portfolio Solutions for SRE. Both Jeff and Margaret are based in San Francisco. Thank you both for joining me and welcome to RPM.

JG: [00:00:49] Well, Margaret, you and I have both reached the stage of our careers where we might be considered seasoned real estate industry veterans. And I think we both agree that even in the context of our lengthy careers, these are extraordinary times. Historically low interest rates followed by an abrupt increase in rates, geopolitical turmoil. And let's throw in a pandemic to the middle of the mix. And the real estate market is on an interesting run. You and the Stepstone Real Estate market research team just completed our semiannual House Views report, which addresses the impact of this environment. What are some of the key takeaways you can share with us?

MM: [00:01:23] So there are three important takeaways, as real estate prices are now adjusting to higher interest rates. 1) More expensive, less available debt is starting to cause real challenges for levered owners. This is increasingly leading to a need for recapitalizations and distressed or motivated sales that set the stage for an excellent vintage year for the non-core and secondaries investments. 2) If you're a lender, that is a great place to be. Rates are high, spreads are wide and you get to be very selective. And yes, some debt is penciling into equity level returns. 3) As the cycle progresses, the story is going to get messy and very mixed by property type. Industrial and residential, especially on the affordable side, and some of the niches are going to hold up relatively well. Whereas office is now making headlines as the big urban landlords feel the pain of work from home and increasingly turned their well known city towers over to their lenders. Now an important note. What I just said affects places with rising interest rates because of central bank efforts to control inflation. So that's the US, Europe and Australia. It is a different story in China, which is just now reopening. Although I'll note that the West got their inflation after reopening, so it's certainly a risk in China. And then Japan, which is amazingly unchanged with lower for longer rates, fat spreads, there's no room for work from home. So B office and other strategies still make a lot of sense. So that's the big picture.

JG: [00:02:47] So, Margaret, to recap, you think there's going to be good opportunities found in distressed debt buys or any kind of distressed distressed buys, whether it's debt or equity? Recapitalizations also lending in the market with a higher interest rate environment. So this is all going to happen with quite a bit of noise as markets correct and adjust to higher interest rates and prices settle. We thought COVID would be hard on real estate owners, but the central banks flooded the system with liquidity to prevent that. Now, as the adjustment period for all that that we've been waiting for for a few years.

MM: [00:03:18] Yeah. So in 2022 we had broad public market stocks and bonds quickly adjusting to higher interest rates and also the public real estate, the reits, adjusted down around 25%, which is probably a decent reflection of intrinsic value, although there are some very important differences between public and private real estate portfolios and behavior. Then private real estate trading prices seem to be starting to adjust. Green Street has them down about 13% in 22, which is not enough. And fund returns haven't really changed that much at all because the reevaluations need more depth of trading. This is all happening amid a 65% drop in volume, that's recorded volume, in the fourth quarter of 22, probably more than that and even more since because the widening bid ask spread meant fewer trades closed. Our information says most of last year's trading was profit taking geared at rebalancing.

JG: [00:04:12] So where do we go from here, Margaret? Everyone agrees that real estate is overvalued, but how and when do prices adjust? When does a market become functional again and when do volumes increase?

MM: [00:04:21] So what we have is building pressures on leveraged owners that ultimately forced sales and thus repricing probably over ‘23 and ‘24. New debt is 2 to 3 times the price it was at the beginning of ‘22. And that's if you can get debt, which is a very big if at the moment, and more so than before, with the banks under stress. These higher costs also imply lower debt proceeds. Although we talk about debt and loan to value terms, it's really sized based on debt service coverage. So you double the costs and you get less than half of the loan size. So if you try to refinance, your new loan is going to fall very short. This whole issue is what started to create the bid ask spread. Even in ‘22 bidders had to deal with these realities, and most sellers were not then motivated enough to take the lower prices so the sales didn't close. Now, if you're an owner facing a loan or cap maturity, these can be very big pain points because you have to fund a huge gap. A lot of owners are having really hard conversations with their investment committees and investors. The first thing they have to do is sharpen their pencils on what it actually takes to get the property stabilized and sold and what they're going to be worth. The real challenge is here, of course, are on the non-core owners who are usually 55 to 65% levered or more, and they have transitional strategies.

MM: [00:05:47] So they actually have to do leasing to stabilize their income, which they can't do until they finish whatever CapEx is under way. And that takes time. So they need time and money to keep their assets. So they have three choices. They can fund it, raise it, or sell it. So history tells us that a lot of the dry powder and existing funds do does go into protecting the existing assets that are deemed worthy. If you don't have it, though, you have to raise it to keep your asset. And this is hard in an environment where many investors are constrained by the denominator effect. But if your asset is likely to be in the money, you really do want to find a way to stay alive till ‘25, which is the new rallying cry and hopefully sell a stabilized asset at a profit into a normal market. So recaps and GP-led secondaries look very appealing to owners even if they are expensive. And then the third thing is sell it. And here you may have the owner or the lender selling. Some things owners are going to be forced to sell. They're not going to be able to save everything. And others, mainly office, are so underwater versus the loans, that it's really over to the lender one way or another. And right now, the market's in a dance of you take it. No, you take it. That will eventually get sorted and resolved. And that's part of why things take time.

JG: [00:07:04] So so, Margaret, what you're talking about really applies to all asset types. But I think most profoundly, it's the office story right now, correct?

MM: [00:07:12] Yeah. Those are the ones that are so underwater versus the loans. And we think that what will happen to office is going to look a lot like what happened to retail post e-commerce. So the income got hit. There was growing uncertainty over the future. A lot of bad news. People lost hope. The capital markets shunned it and prices fell a lot. Meanwhile, tenants got smart about things like omnichannel and everybody got a lot clearer about which formats and locations would work and how. And 10 to 15 years later, retail found a solid bottom. And it's starting to look interesting again.

JG: [00:07:48] While we're seeing a lot of headlines on office, it's in a very different place than other property types, which makes up most of many portfolios. So let's address those other property types.

MM: [00:07:57] Well, most of the problem is capital markets oriented. So it is going to hit everything, including good owners with good properties, but again, with a higher impact on the higher leveraged assets. To this end, it can create windows to enter highly desirable assets, including more core like high quality industrial and medical office that had been previously too expensive. While not immune from cyclicality, the other property types have countervailing forces that are providing lift. So industrial is in high demand still because of e-commerce plus regionalism, and many tenants want to build up some just in case inventory post-COVID, which has been challenging given the tight space issues. Residential, particularly affordable and here I mean both small, a naturally occurring, affordable and big A, that end of the market is in short supply and a lot of niche property types led by tech change, such as data centers, production studios and life science, have resilient demand drivers. In all these cases, the cycle softening is likely to hit the less well located, less well designed and managed properties, harder, which is why we at Stepstone have always emphasized the importance of selecting quality GPs and operators and doing good due diligence. For example, life sciences is maturing after a bit of a gold rush and the late entrants, the less skilled, the less well connected ones are definitely in for tougher sledding.

JG: [00:09:19] What about core real estate? How are existing core portfolios faring?

MM: [00:09:23] So core is sort of in limbo now, waiting for repricing. The US Odyssey funds have $25 billion in outflow queue and managing that is their big issue right now. Their leverage average is 20%, so it should be manageable and they are working to keep dry powder for some of these interesting buying opportunities that I mentioned to take care of the folks that are not I'm hitting exit. And by the way, that queue is mostly rebalancing. It's not investors completely exiting. They have gated and they're projecting 4 to 6 quarters at least to work through the queues. We'll see what happens there. We don't recommend and entering open ended funds until they reprice to a level that's more in line with current interest rates. Also, although the better fund owners have really worked down their office exposure, the US Odyssey is in aggregate 20% exposed to office. That really needs some work out. And by the way, if they tell you don't worry it's it's Life Sciences office, it's probably still you should worry. And we're going to watch all of this and focus on giving our clients information about how to proceed over time. So then when all the repricing is finished, what it's really doing is shifting real estate to higher yields. So you'll have these more resilient income streams on lower pricing. That leaves real estate projected to be among the better returning asset classes over the next five years, even including a down year in ‘23. So Oxford Economics has delivering in the low fives, which is above stocks and bonds. And then real estate will continue to serve its important role in portfolios providing current income, inflation, protection and diversification. Those latter two were big in ‘22 and attractive risk adjusted return. The ‘23 and ‘24 vintages are shaping up to be able to deliver very attractive risk adjusted returns for those able to provide debt or rescue capital or those buying properties from motivated sellers who couldn't fund them.

JG: [00:11:24] Thanks, Margaret. As always, your views on the market were very insightful. We all thought that the pandemic was going to lead to dislocation in the general economy and the real estate markets. But the central banks' infusion of liquidity into the system by lower interest rates fended it off. But paradoxically, it has helped contribute to the inflationary environment that we're in now, which has caused property values to decline. So now we have our dislocation but little trading activity. When property owners loans mature and there's $2.5 trillion of debt maturing in the next five years in the US alone, trades will commence at the lower values. Until then, recapitalizations to pay down overlevered real estate will be the name of the game. We think that the vintage ahead is going to be a great time to take advantage of distress in the market and drive attractive returns. Thanks, Maribel. We really appreciate your having us.

MM: [00:12:11] Our pleasure. And there's lots more on this in the Full House Views report.

MY: [00:12:15] And that does it for this episode of RPM. Thanks for listening. For more research and information on Stepstone Real Estate, visit us at www.stepstonegroup.com. Rpm is available on Apple Podcasts, Spotify, Stitcher and other podcast platforms.