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November 2024 • perenews.com

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Fed fuels hopes of US real estate recovery

Interest rate cuts could encourage greater activity as market turbulence begins to subside, but not in the short term, say participants in PERE's US roundtable discussion. Stuart Watson reports

As the participants in *PERE*'s US roundtable discussion meet on September 18, the Federal Reserve is expected to announce a 0.25 percent cut in its key borrowing rate. However, it later transpires the central bank begins its easing campaign with a more aggressive 0.5 percent cut, lowering the federal funds rate to a range between 4.75 and 5 percent.

Good news for a US real estate sector battered by two years of volatility? Probably yes, is the roundtable participants' verdict. But even a larger-than-expected cut is unlikely to produce a material impact in the short term.

A rate cut is already "baked in" by the market, says Justin Gleason, managing director at global investment manager PGIM Real Estate, and portfolio manager for its US core-plus strategy. "Real estate is really priced for longer-term rates at this point. But this does maybe get some people off the fence on selling or transacting."

The signal that rate rises are over, at least for the short term, will bring "a little bit of hope and stability," says Kyle Jeffers, chief investment officer for commercial real estate debt provider ACORE Capital. Owners of assets that currently have issues with their capital structure might be prompted to take advantage of some of the undeployed capital raised recently and exit those positions, he suggests.

Interest rate reductions will likely have a positive psychological impact, but there are plenty of other unresolved issues of concern for investors, adds Stephen Rabinowitz, co-chair of the global real estate practice at law firm Greenberg Traurig.

"We are dealing with a lot of distress across different sectors, and there is so much uncertainty over inflation, global political instability and the presidential election. Rate cuts could prompt an increase in activity, but there is a question of how long that will last in such a volatile macro environment," he says. "Cutting rates could impact inflation, which might make people skittish again."

Inflationary pressures could persist, comments Eric Wurtzebach, global head of real estate at Macquarie Asset Management, because whatever the outcome of the election both Republicans and Democrats expected to continue significant spending. "Post-election, I am interested in whether the Treasury starts more aggressively pushing banks to mark-to-market the real estate loans on their books."

Bid-ask spread

CBRE research shows the trailing four-quarter volume for commercial real estate transactions decreased by 32 percent year-on-year to $341 billion in Q2 2024, the lowest total since Q2 2013. Can buyers and sellers now be

PHOTOGRAPHY: DANNY SANTOS

Stephen Rabinowitz

Co-chair, global real estate practice, Greenberg Traurig

Rabinowitz is co-chair of the global real estate practice at Greenberg Traurig, a global multi-service law firm with more than 700 lawyers focused on the real estate business. A significant portion of his practice is devoted to venture formation and engineering sophisticated capital structures.

Ryan Krauch

Senior managing director, Affinius Capital

As senior managing director, Krauch leads the development of key strategic initiatives and relationships for Affinius Capital. The firm, which was created by the merger of USAA Real Estate and Square Mile Capital, manages around $64 billion of AUM invested across both credit and equity strategies in North America and Europe.

Eric Wurtzebach

Global head of real estate, Macquarie Asset Management

In addition to his role as global head of real estate, Wurtzebach leads MAM Real Estate's principal investment and asset management activities in the Americas. MAM Real Estate's opportunistic AUM, combined with its proportionate share of investee platform AUM, comprises approximately $10 billion of assets.

Kyle Jeffers

Chief investment officer, ACORE Capital

Jeffers is CIO and a member of the investment committee at commercial real estate debt manager ACORE Capital. The firm originates CRE loans across the capital stack from senior debt to mezzanine and preferred equity and manages $19 billion total AUM.

Justin Gleason

Managing director and US core-plus portfolio manager, PGIM Real Estate

Based in San Francisco, Gleason has a leadership role in all aspects of core-plus fund strategy and management for global real estate platform PGIM Real Estate. The firm manages around $200 billion of real estate assets in both equity and credit strategies.

confident that values have bottomed out, encouraging a pick-up in investment activity?

There is "growing consensus" the NFI-ODCE Index will reach its low point in 2024, says Ryan Krauch, senior managing director at San Antonio-based manager Affinius Capital, although he questions whether office assets in these open-end diversified core funds have been fully repriced yet.

"Values have taken two years to correct, but now rates are coming down, the bid-ask spread is going away and inflation is moving in the right direction. Add all that together and there is a sense that we are at the bottom from a real estate standpoint, and the fundamentals are still pretty solid," suggests Gleason.

Debt markets will need to be sufficiently liquid for transactions to happen, however. That is still questionable right now, says Jeffers, because regional banks are largely out of the market for real estate loans while money center banks are focused on managing their existing loan books. The introduction of the Basel III financial regulations could further constrain bank lending by forcing them to bolster capital reserves.

He adds the increased willingness of banks to provide back leverage in the form of repo lines to real estate debt funds is a positive development, however, and there is some prospect that lenders' cost of capital will begin to reduce. "If that happens, we will start to see more attractively priced debt, which encourages buyers and sellers, and with a little more activity it will become clearer what values should be."

Numerator effect

Capital formation in the US private real estate market has been hit hard of late. *PERE* data shows only $46.7 billion was raised for North American private real estate strategies in Q1-Q3 2024, down from $62.5 billion during the same period in 2023. But there are now indications of a few green shoots,

> *"When everybody was just buying assets and waiting for cap rates to compress it created an unrealistic expectation"*
>
> **RYAN KRAUCH**
> **Affinius Capital**

say the roundtable participants. "It has been a super-depressed few years of capital raising, the worst I have ever seen in my career," observes Krauch.

The denominator effect caused by the falling value of equities initially impacted investor allocations to real estate, and while much of that effect has been eliminated by a recovery in share prices, the bond market is still lagging, he notes. Meanwhile, real estate also has a "numerator problem," he adds. "By not marking our assets down fast enough like the public markets did, the industry has done itself a disservice."

Investors generally have been content to park their money safely in bonds while waiting until the returns available in real estate are worth the risk again, says Rabinowitz. "Our real estate funds practice is starting to get a little more active again, but there is still a lot of dry powder on the sidelines that hasn't been deployed."

Many real estate equity investors have migrated to the credit space, says

"Rate cuts could prompt an increase in activity, but there is a question of how long that will last in such a volatile macro environment"

STEPHEN RABINOWITZ
Greenberg Traurig

Data, AI and real estate

Participants consider the impact of new digital technologies on the property market

In the real estate industry, as in the rest of society, getting to grips with the implications of artificial intelligence and the ability to collect and analyze greater volumes of data is leading to some head-scratching.

"The real estate industry has never been considered to be on the cutting edge of tech. Those managers that are able to understand the winners and losers from these new technologies will be better placed to generate alpha for their clients," says Macquarie Asset Management's Eric Wurtzebach.

Nonetheless, the participants' firms have begun tentative efforts to explore the business-enhancing potential of data technologies. Affinius Capital's program to collate and organize its data is taking longer and costing more than anticipated, says Ryan Krauch. "But once you have it, it is amazing what you can do with the data."

Wurtzebach notes that MAM's approach leverages insights from its broader real assets platform to enhance market and sector-specific investment strategies, including investing in logistics. "Connecting those dots can be very powerful in an environment where supply chains are evolving in response to geopolitical risks."

Greenberg Traurig is experimenting with AI to create first drafts of documents, which can subsequently be checked and if necessary amended, says Stephen Rabinowitz. "It's not at the point where you can just have AI produce something that you can give it to a client. But there are certain things we can do really well with AI, for example document review and proofreading. In all cases we would only use it with client consent."

Over time he expects AI to undertake a constantly increasing proportion of the routine tasks associated with practicing law, making operations more cost-effective.

The real estate industry is still "some way off" making full use of AI, says PGIM Real Estate's Justin Gleason. Part of the challenge with data is figuring out how to "ingest" it so that it is accessible in a useful form, says Krauch. "AI can help with that, and that will accelerate the progress of data science far faster."

Jeffers. "People forgot for a while that they could lose money in real estate equity. Then when values fell, they realized they could go into credit and get pretty close to the same return, and with a 30 or 35 percent subordination in their position which means it's a lot lower risk."

Wurtzebach believes the potential to miss out on excellent buying opportunities can draw investors back to the asset class. "If you combine the sharp pullback in new supply with interest rates falling and the fact that there are a lot of broken capital structures that will need to be restructured, we expect that 2025 should be a good vintage for real estate funds. I have heard far more interest in investor meetings in the last three months than I have in the prior three years."

Many investments are still structured as traditional joint ventures, with sponsors less inclined to employ funds or REIT structures because of the greater administrative and regulatory compliance burden, says Rabinowitz. However, he notes there are some "creative hybrid entities" emerging in which sponsors collect a bucket of assets and then market them as a fund structure.

A growing number of investors want to have more influence over assets, and they are showing increased appetite for investing directly in operating companies, observes Wurtzebach. "They want opco exposure as well as LP real estate exposure. They think their access to worldwide information can be additive to how those businesses operate at a local level."

Niche sectors

Despite the market volatility, investors can also access opportunity in the real estate space by investing thematically in undersupplied sectors, argues Gleason. "There are things that you can structure your strategies around that can act as a guidepost and transcend some of the uncertainty out there." He notes that meeting the differing rental

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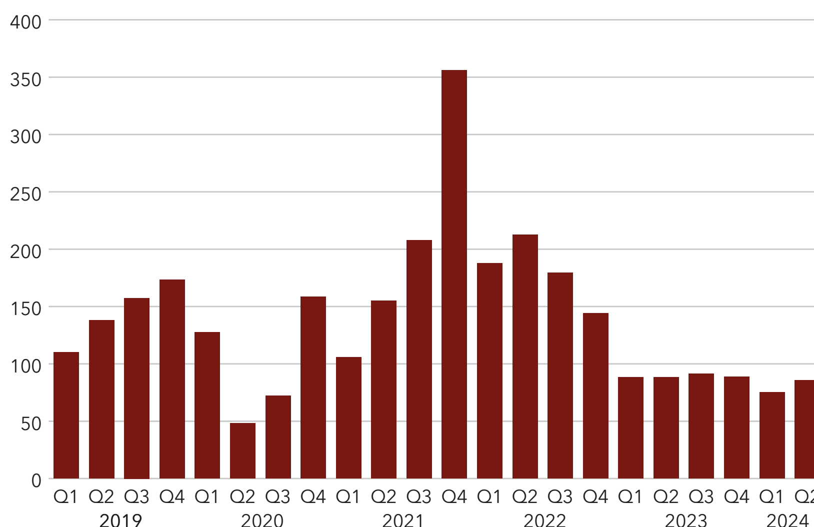
>
> **JUSTIN GLEASON**
> **PGIM Real Estate**

Commercial real estate transaction volume fell by 3% year-on-year in Q2 to $86bn, but was an improvement from the 15% drop in Q1 ($bn)



Source: CBRE Research, MSCI Real Assets

housing needs of the two demographic "bulges," the baby boomers and millennials, and digital transformation are key themes.

"There is a shortage of housing in the US and construction starts are down, so the fundamentals are great, and industrial is also undersupplied," says Jeffers. "You have to segregate office from the other asset classes because it is going through so much change."

The investable universe in real estate has evolved, says Wurtzebach. "Practically speaking, there used to be four asset classes. Remove retail and offices, and that went to two. The niche asset classes are now the third popular bucket for investor capital alongside industrial and living. Specialist knowledge helps gain access to niche sectors though, which is reinforcing the demand for opco exposure from many investors."

Investors need to bear in mind that emerging sectors such as data centers, cold storage, life sciences and energy projects are very capital intensive, says PGIM's Gleason. "The returns are there, but they are not for the faint of heart."

He identifies data centers as a "hot topic" among investors right now because of the surge of demand from cloud computing hyperscalers. "There won't be any shortage of capital chasing the sector. The gateway issue is access to power."

Gleason also singles out senior housing as the sector he feels "most bullish" about currently. "It has bottomed, the supply is about to drop off and there are great opportunities to acquire distressed assets. It is primed to take off just at the time that the first boomers turn 80."

Krauch points out the average age for people to move into senior housing is 83. "We all thought it would start happening 15 years ago for the baby boomers. Everybody got really excited about it, and then said, 'Wait, where is everybody?' And it was because people delayed moving into their 80s. Now we are finally seeing the demand materialize."

Macquarie has been active in niche asset classes including manufactured housing and self-storage, but the firm has been more cautious in others including film studios and life sciences. To be successful investing in niche sectors often requires ownership of strong assets in very specific geographies, while there is a limited opportunity to partner with skilled operators, warns Wurtzebach.

> *"People forgot for a while that they could lose money in real estate equity"*
>
> **KYLE JEFFERS**
> **ACORE Capital**

"In some niche sectors where there is significant institutional demand there are bound to be mistakes. Some operators are not as well qualified and might operate in secondary or tertiary markets where oversupply risks only become obvious during periods of elevated volatility. We are seeing the results play out today," he says.

Opportunistic credit

Amid the market uncertainty of the past two years, many real estate investors have chosen to deploy their money in the credit space. "Right now, we are seeing a lot of interest in debt investing among our clients because the perception is that's where they are getting most bang for their buck," says Rabinowitz.

While the risk-return profile of equity investing will vary through the cycle, real estate credit is now an established element of many allocations, says Krauch. "Most investors now recognize that whatever point you are at in the cycle some exposure to real estate credit is a good thing. It's just a question of where they choose to play in the capital stack."

Workouts of defaulting loans have been a feature of US real estate markets of late. "There are a lot of people selling debt and there's an opportunity to buy it and get to the assets at a great basis," says Rabinowitz. The participants agree that workout situations have become less contentious over recent years, with most borrowers and lenders focused on finding the most efficient way of restructuring capital stacks.

With a wave of refinancings expected to happen over the coming year, and many banks preferring to reduce risk by lending at lower LTVs, there is an attractive opportunity to plug the gap between debt and equity, says ACORE Capital's Jeffers. "We are seeing a lot more interest in the opportunistic credit space that lies between equity and senior debt in the 65-85 percent range. It is a hybrid for investors who don't want to invest in equity because they want more safety, but they want a little more juice on their return than they can get in senior credit."

Assessing risk

The US is on the eve of what is widely regarded as a potentially historic presidential election. But the impact of the vote on real estate will probably be limited, says Rabinowitz. "The perception is that election day is going to be this great thing. But no one can really identify the risk of a Democratic or Republican win. For instance, it's unlikely either party will tax capital gains more heavily."

He has noted accelerated efforts to get certain transit or energy-related transactions completed before the end of the year while valuable Inflation Reduction Act benefits are still available, however.

The participants are cautiously optimistic about the outlook for US real

No easy solutions for US office sector crisis

Investor sentiment is beginning to shift, but rebasing still has a long way to go

Stories abound illustrating the plight of America's office market. One notable recent example is 360 Park Avenue South in Manhattan, which sold for $300 million in 2021. Earlier this year Canadian pension fund CPP Investments handed over its 29 percent stake in the 20-story tower to one of its partners, walking away from commitments to fund $45 million in upgrades, in exchange for $1.

However, the roundtable participants sense a change in sentiment regarding the beleaguered sector. Investors may not be ready to buy offices again, but they are starting to talk about it. Gleason says he is hearing from brokers that interest is beginning to "creep in" from investors considering whether to back strategies for acquiring distressed office assets. "I am not suggesting a short rebound in office, but the gears are unlocking a bit."

Over the past few months, the conversation surprisingly has quickly shifted from "how do I get out of office" to "is now the right time to go back into offices," says Wurtzebach. "But few real estate teams want to take an office deal to investment committee yet, particularly those with large existing exposure."

"The net effective rent compared to the owner's basis needs to reset for office ownership to make sense again," says Jeffers. "We will get there, but it is taking a while to flush through the system."

Rabinowitz says Amazon's recent mandate that employees return to the office five days a week is an indication that working practices may shift once again. "Eventually someone is going to lose a job for not coming into the office, and the next thing you know, all offices are going to be full four days a week."

Several efforts to convert older office buildings in New York to residential have found financing and are underway, he adds.

Only a small proportion of office buildings are suitable for repurposing without subsidy, and there will never be enough money available to incentivize every conversion, cautions Krauch. "It took the market several years to figure out how to convert large obsolete shopping malls into something useful. It may take longer with offices, because the alternative use case is not as obvious."

> *"2025 should be a good vintage for real estate funds"*
>
> **ERIC WURTZEBACH**
> **Macquarie Asset Management**

The 10-year Treasury rate is expected to remain around 3% to 2030, well above the 1.9% average between 2009 and 2019 but low enough to drive recovery in real estate values (%)

Source: CBRE House-View, September 2024

estate investing conditions in 2025. If a hard landing and recession can be avoided, they expect the 10-year risk-free rate to stabilize at 3.5-4 percent. Meanwhile, asset prices are gradually resetting, a process Krauch describes as a "painfully slow drip" that will continue for a while longer.

During the era of ultra-low interest rates, the challenge facing many managers was how to deploy capital. They can now return to focusing on what they are good at: assessing risk, argues Wurtzebach. "We like where the market is. We think there are great opportunities because the disparity in return for different assets and geographies is wider than it has been in years. If you can assess risk well, you can find very good risk-adjusted returns."

"For a while timing became the dominant factor in real estate investing," adds Rabinowitz. "You bought at a certain time, you waited for cap rates to do their magic, and you sold it. We're getting back to a place where to create value in real estate you need vision, creativity, experience and management expertise."

Krauch agrees with that assessment. "Traditionally, real estate investing was about income-producing high-quality assets and hedging against inflation. When everybody was just buying assets and waiting for cap rates to compress it created an unrealistic expectation," he says. "But the question is whether investors will still expect 20 or 30 percent returns when that isn't generally what real estate investing is supposed to produce. When it reverts to the traditional role that it should play within their portfolios, will they continue to allocate the same volume of capital to real estate?"

That question is likely to be answered only when the current turmoil subsides, and the market reset is more advanced. In the meantime, US real estate investors will be keeping an eye on the opportunities emerging from the shake-out. ■