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Michael Venne: You're listening to R.P.M., the podcast that explores the world of private markets. I'm your host, Michael Venne. On today's show, Kieran Farrelly joins me to discuss the evolution of Real Estate Secondaries. Kieran joined Stepstone in 2017 and works out of our London office. He is a CFA charterholder and holds a PhD in Real Estate and Planning from Henley Business School. Hi, Kieran, and welcome to R.P.M.

Kieran Farrelly: Thanks, Michael. Great to be here.

MV: So, Kieran, most of our listeners will be familiar with private equity secondaries. Could you briefly discuss some of the ways that real estate secondaries are similar or different?

KF: No problem, Michael. There are a number of similarities and differences given the various nuances of the two asset classes. So, look, first of all, I would say real estate has a greater breadth of available risk return strategies. So, from lower risk core through to the more opportunistic higher risk strategies. And these are available to investors through a range of fund structures. And so, for example, one big difference with the PE secondary market is that there is an active market for lower risk strategies in real estate executed through open-ended or perpetual vehicles. You know, our market in real estate for the closed-ended private equity style funds is much smaller, and, as a consequence, there are fewer secondary opportunities through that typical LP structure, and therefore fewer market participants and specialist buyers. Now, the similarities, like private equity, are that we're seeing significant growth and a growing volume of GP-led activity through recapitalizations, fund windups, and secondary directs. So that evolution is really taking hold in real estate as well. And then a number of the benefits to LPs from the secondary strategy applied in exactly the same way in real estate as they do in private equity. So, whether that's J-curve mitigation, discounted entry pricing, the diversification benefits provided, and, finally, the reduced execution risk again of benefits that draw LPs potentially to a real estate secondary strategy.

MV: I guess perhaps another difference between the two would be in how they evolved. You know, a lot of the times we see innovations, like the secondaries market, coming about in more competitive and more mature markets. But in the case of real estate, which is older and larger than private equity, this innovation occurred later. Why is that?

KF: Well, Michael, a healthy secondary strategy is reliant on a deep primary market, and much of real estate is, in fact held outside of the fund construct, especially the closed-end funds construct. And so, to give you a sense of that, approximately half of the global real estate transaction activity last year in 2019 was executed by non-fund entities, according to Real Capital Analytics, who track that data. So, the primary market, if you like, for these closed-ended private equity style funds, only got going in meaningful scale from around 2004. And it was really a function of that dynamic that allowed the secondary market to commence and evolve. So, borrowing from the lessons learned and approaches developed in the private equity market, there are now a relatively small cadre of well-capitalized real estate secondaries investors and recapitalization liquidity providers in the market. Many of these grew out of the existing private equity secondaries platforms.

MV: So, how do investors seed a real estate secondaries program? Does it come from their real estate program or if they have one, does it come from their PE secondaries program?

KF: That's a great question. Our experience has been that it tends to come from the real estate allocation and really seen as a strategy that augments and complements existing portfolios. So, for example, investors will use the strategy to help ramp up the broader real estate application. They may use it, for example, to simply broaden the opportunity set from which they can allocate to. And finally, it can be very complementary, for example, a potentially attractive way of accessing specific markets and strategies.

MV: It's quite fascinating. In our latest white paper, we note that secondaries AUM has grown more than 1000% since 2009. What were the main drivers of this rapid growth?

KF: So, given the primary market really only got going in scale from 2004, the post GFC period was really the first, if you like, downturn where real estate LPs were holding closed-ended real estate fund positions on the books. And it was really that post GFC period that introduced real estate investors to the benefits of a secondary market, particularly portfolio management, and ability to rebalance portfolios, and finally its ability to provide liquidity where that was needed. And one of the big catalysts for really getting the market going in some degree of scale, were the regulatory changes that took place during that period. They provided a real impetus, and so, for example, the way that the Basel III and Solvency II regulatory capital requirements were bearing down on banks and insurers, meant that they were in a position where they had to dispose of their illiquid holdings. And as I said, for the first time that included real estate closed-end fund positions, and the market is really grown from there.

MV: And I should think investors familiarity with private equity secondaries played some part. You know, one of the things our PE secondaries team often discusses is the importance of carving out a niche in the less efficient parts of the market. Is the real estate secondaries market sufficiently mature that such a niche exists? Or is the market still too young?

KF: You know, I would frame it a little differently, Michael. I think for us, we tend to think about capturing inefficiency and ultimately mispricing in the way in which we approach the market and also structure our investments. So, for example, at Stepstone, we have access to extensive information and data on the funds and programs themselves, and we're able to bring that information to bear in the marketplace. And so, whether that's in an auction process (which we do tend to avoid, but where we tend to find we do have some information advantages, and that can be extremely helpful), and similarly, where we have a strong preference for transacting is where we do that more directly with the GP. And again, that relationship facilitates a greater sharing of information. So, again, information is key in this market, and it can really help make a difference in terms of how you price an opportunity. I would say, secondly, more broadly, it's just ensuring that you've got as many investment conduits as possible in your opportunity set. So real estate is a global asset class, and there are a myriad of holding structures, in multiple jurisdictions, available to investors. And again, even just the accounting policy followed by some of these vehicles can have a meaningful bearing on value versus price. And look, in relation to structure, I would also say we approach the market very flexibly. And so, for example, when thinking about recapitalization situations, we're very comfortable pricing debt or preferred equity structures, we are equally as comfortable doing that as we are the more standard common equity type opportunities. So again, that whole area of structure is an area where one can capture the inefficiency. And then finally, we think there's a particularly interesting opportunity for a lower risk return or call the core-plus type strategy dedicated to secondaries, where one is looking for a blend of income as well as capital gains. And I think having that type of cost of capital, which we believe to be appropriate, a number of situations, we see, you know, depending on the underlying risk profile of the opportunities and the consideration. But we think matching that that appropriate cost of capital with the appropriate risk profile really, we find could enable us to unlock some substantial niches and opportunities in the market.

MV: So, it sounds as though this may be a good time for LPs to consider making an allocation to real estate secondaries. Should investors think of real estate secondaries as an all-weather strategy as opposed to call it a countercyclical, something they turn to when times get tough?

KF: Well, look, in our view, it has the ability to be in all-weather strategy, although that strategy should adapt to the stage of the market cycle. So, looking in downturns, or post downturns, the distress created, if you like, creates a need to fix situations. So, whether that's providing liquidity to help ease, their need to rebalance their portfolios or simply need to make payments to underlying beneficiaries in a quicker than usual manner or whatever the case may be, that distress typically creates additionally discounted pricing. On the flip side of that, one is also in a more uncertain environment and so it has to underwrite prudently as a consequence. Certainly, those downturn periods create opportunities for elevated levels of performance, all things being equal. But look, when markets recover and normalize, there remains plenty of opportunity. So, for example, if I think about recapitalizations, going from a period of where you need capital to fix situations, you then transfer, if you like, to a period where you need capital to grow situations. And so that shift from fixing to growing again, that plays out through cycles. And look, finally, the lower risk opportunities in the space, I think, really come to the fore as you progress through towards the late cycle, where the attractive entry route of secondaries augmented with income can really be a very prudent and interesting component of a real estate investors portfolio.

MV: Really interesting. Finally, Kieran, one more question. The covid-19 pandemic has affected all parts of the market, but perhaps none more tangibly than real estate. What sort of advice would you give to investors looking to deploy capital in the current environment?

KF: The down-cycles, like the one we anticipate going forward from the consequences of the pandemic, often trigger the greatest need for liquidity on behalf of investors and their holdings. So, look, it's critical that one avoids falling knives. And to do that, you require a diligent underwriting approach and a healthy dose of patience. So, in this scenario, given the risks of further rental falls, declining occupancy, value falls as a consequence of capital market movements, as well as the losses that one could incur through loan foreclosures, all of that needs to be considered in a very conservative manner and conservative assumptions should be employed to underwriting as a result. So, as I say, avoiding those falling knives is absolutely crucial in all downturns. This pandemic is clearly unique and it's really impacted real estate markets significantly, and incredibly unevenly across product types and geographies. We're seeing that coming through in the reported operational performance, and we all know that we're staying in hotels less and generally shopping in physical space a lot less, and these are dynamics that investors should be incredibly wary of as a consequence of this specific pandemic induced downturn. And so, these structural trends that we see accelerating again could lead to increased caution in certain areas of the market.

MV: Kieran, thank you so much for your time. Stay safe and hope to see you again soon.

KF: Likewise, Michael. My pleasure. And look forward to that one.

MV: That does it for this episode of R.P.M. Stay tuned for new episodes every few weeks. And please be sure to follow us on Apple podcasts, Spotify, Stitcher or wherever you get your podcasts. If you enjoy this episode. Be sure to read the accompanying white paper, which explores real estate secondaries in greater depth. To learn more about StepStone Group, visit us at www.stepstonegroup.com.