STEPSTONE

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RPM Ep 37 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 discussing our Fall 2023 Real Estate House Views. This covers the state of the markets, leveraging the StepStone real estate team's daily global interactions with market participants, including meetings with GPs that are running this year at an annual pace of 1000. This market engagement was enhanced as StepStone Real Estate is on track to allocate over 10 billion to private real estate in 2023, a much reduced pace relative to 2022 due to market wide dysfunction. Joining me to guide today's discussion is 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. Thank you both for joining me. I'm excited to welcome you both back to RPM.

Jeff Giller [00:00:44] Thanks, Maribel. Margaret, you and I have conversations about the real estate market just about every day, so I don't expect this discussion to be any different just because we're mic'd up. And since we've known each other for a couple of decades and have both seen a lot, it makes these conversations even more fun. It's sort of scary that we've known each other for two decades, and we were already pretty seasoned veterans when we met. I think they call that being cycle-tested right? I must say that in my nearly four decades in the private real estate market, I have never seen this profound a level of change in the way physical space is being used. The changes in space use are being driven by social and behavioral changes that were catalyzed and accelerated by the pandemic, and also by innovations in technology, and then overlay a 500 basis point spike in interest rates from historically low to cyclically high levels, causing extreme dysfunction in the capital and transactional markets. And, well, you certainly had a lot to address in the StepStone real estate house views. So you oversaw and just released to kick off our conversations, can you share what you think is the biggest change in the environment from the point in time when our Ppring House views were published to now?

Margaret McKnight: [00:01:46] So the big difference from the spring house views to now is that the normally slow real estate cycle has actually progressed and it's at point that loan workouts are beginning in earnest. This is creating both turmoil and opportunity and we want to make sure our clients are focused on the opportunity. Higher interest rates lift borrowing costs first for floating rate lenders and then for all borrowers, and they that mean properties can support less debt, and so loans need to downsize at maturity, levered owners face funding gaps now that increasingly need to be addressed. Prices are falling in response to higher rates; the Green Street CPPI trading price index is down over 20% as cap rates lift above borrowing rates and returns eventually move up to reflect base rates plus risk spreads. As we go forward, it's important to remember that this is a capital markets driven correction; with the notable exception of office, most property types face decent fundamental outlooks.

So we have the same three takeaways as last time. The difference is they're closer and they're starting to look as interesting as we'd hoped. One, there's an opportunity to provide funding to close the gap and allow the owner to retain the property, which many GPs are inclined to do given the decent outlook for fundamentals, which often means they just need a recap to have time to ride out the capital markets cycle and maybe grow income into the new interest rates. So this is stay alive till 25 or now I've heard fixed in 26, which does reflect that this is going to take 2 or 3 years. This gap capital is very valuable. We're seeing it price at the same levels as the post-GFC period. As an example, one recap we recently looked at was 16% for preferred equity, with downside risk mitigation and upside participation on a portfolio of quality properties with a bright fundamental outlook. Our favorite way to play recaps is via what we call GP led secondaries, because there you're solving two problems. You fix the GPs funding

gap and you take out LPs who want liquidity. Then second, not everything can be saved. Probably far from it due to lack of capital. There will be motivated or distressed sales benefiting value-added and opportunistic investors. This includes sales of stronger assets to fund internal recaps of assets that are still in transition, and loan sales, which, among other things, offer the potential to own the asset for the discounted loan price. We're advocating investing with managers who have experience accessing and navigating distressed opportunities. And then third, it's a very attractive time to be a lender. Transitional lending at reasonable attachment points is priced for low teens returns. Bank lending is way down, and we're likely to end the cycle with more non-bank lending. On the other hand, the open-ended funds are not a good place for new money now. The appraisal process is slow, and it means, for example, the ODCE index NAV, the net asset value, which is the price you buy and sell at in both the US and Europe, has dropped about half as much as green streets CPPI, which is the trading property trading price index. Investors are very frustrated and there's real pressure to reevaluate the appraisal process. It's leaving allocations bloated just at the moment when investors would really like to be deploying into the very interesting options I just mentioned.

JG: [00:05:08] Interesting. But the closed end funds are also contributing to the problem, right?

MM: [00:05:12] Yes. So the problem is exacerbated by reduced liquidity flows most meaningfully among the closed end funds. StepStone data shows that recent distributions are 68% below the five year average, and capital calls are down by 25%. So investors aren't getting money back to recommit it. By the way, this is also true of lenders. So the normal cycle of both equity and debt capital rolling is really dampened. Just when GPs need capital the most to fix funding gaps, again, the supply demand mismatch is the essence of today's opportunity. And then the committed but uncalled section of LPs allocation is high. GPs aren't buying, trading volumes down, and they're waiting for the market opportunity that's really just emerging. But we can see ripening. They're also guarding capital. They're guarding it to fill funding gaps that are forming. They can't count on sales proceeds because things aren't selling, and they don't have a lot of term on their debt since they funded their short term buy/fix and sell strategies with short term, usually floating rate loans. So a lot of money that was earmarked for new acquisitions and CapEx is going to go into defending existing assets. That mountain of dry powder is not as high as it appears with regards to doing new deals. All in all, new fund commitments are roughly half what they've recently been. Capital flows are slowing just as the need for capital is going up, which sets the stage for better investment opportunities.

JG: [00:06:40] Sounds like what you're describing is an extremely liquidity constrained market, Margaret. Can you talk more about what's happening with property trading volume?

MM: [00:06:49] Property trading volume is down about 40% from its post-GFC run rate globally, but notably it has not dried up like it did during the GFC. There's a big bid ask spread that ends up with less getting done. High interest rates equal lower bid price because most of them are levered. And then on the other hand, the write downs have yet to follow, so owners have help in believing what they'd like to think that values aren't down. Plus, outside of office, there isn't operational distress to force owners to sell at prices they don't like. The trigger for making deals happen is really coming from debt issues. Trading volume is heavily focused on smaller properties and the more desirable property types, which are all of that is much more easily fundable. Both the interest rate volatility and the economic uncertainty are drivers here, and also just the lower availability of debt and equity capital, as we've discussed.

JG: [00:07:40] So pivoting into how space is being used, as I mentioned up front, the way physical space is being used is changing immensely. What does that mean for property type outlooks and what property types are desirable?

MM: [00:07:54] So the big loser and by a wide margin versus everything else is office. And this is both because of the weakening economy and the tech sector pull back. And also secularly in many countries and especially the US, there's a work from home which is unambiguously here to stay. Employers and employees are now in a grand experiment on hybrid work. That's also going to affect the lease structure and even how the office space is configured. Owners and lenders are taking losses, and they're making headlines, particularly around well-known towers. One winner is residential. We now live, work, shop and play at home, so we need more space and also more functional space. For example, mail rooms are not what they used to be. At the same time, higher interest rates make home buying much less affordable, which keeps more people in the rental pool. And there already was a shortage of affordable middle class housing. So generally speaking, the outlook for all the residential formats, especially in the affordable section of the market, is good, albeit with slowing rents. However, the devil's in the details and as always, location matters. So, for example, some of the higher growth US cities have a lot of new supply to absorb, and some European countries are grappling with new or potential rent control laws. Then, of course, there's the star of the show for the last few years, industrial, which continues to benefit from e-commerce and now is also getting a boost from Deglobalization. Rental rate growth is positive but slowing with a good outlook. Also, rates have risen so fast that existing leases are well below market, so there's a lot of embedded income growth that's realized as leases mature. And importantly, that space can be released at the higher rates. So for this reason properties with short remaining lease term are more attractive than long lease terms, which is not the usual order of things.

The hottest trend at the moment is data centers. As computing demands increase beyond what existing providers can develop, like all of the newer niche sectors, there are many new entrants. Experience, skills and network do matter, so careful selection of partners can really impact returns, as followers of the last hot trend life sciences are now discovering as that market shakes out after a bit of a gold rush. We at StepStone put a tremendous amount of resources into quality manager selection. It's an important service that we provide our clients.

JG: [00:10:23] Thanks, Margaret. The market environment that you just described presents a number of challenges for investors to navigate. One, with the built environment changing before our very eyes and significant stock of functionally obsolete properties in every asset category, what real estate asset types should we be investing in? And two, with reported value still high relative to actual market clearing prices, when is the right time to start putting capital in the market? With respect to the first point, our house views report indicates that we continue to believe that all forms of rental housing will continue to perform well, as the cost of ownership continues to stretch beyond many people's reach. As you pointed out, industrial will continue to benefit from the growth in e-commerce, and we now think that retail has found its footing and certain formats will present attractive opportunities. Office is going to be tough for a long time, as it's suffering from the trifecta of work from home, functional obsolescence, and the cost of ESG retrofitting and even great office, it doesn't face these issues. Will we be punished by the capital markets in the form of a lack of liquidity and cost of funds? The important question is when will the transaction market begin to function again? Of course, it's difficult to pinpoint a date, but it will happen when property values are either written down to realistic levels by their owners or lenders take over the assets. We'll see this happening more and more, as the nearly $4 trillion of debt that's maturing in the US and Europe over the next four years becomes due. But it's key to point out that investors need to allocate capital in the near term to managers with the skill, discipline and proven track records investing successfully in market

troughs. If they don't do this, then they're going to miss the market opportunity and risk investing back into market peaks. I'd love to spend a couple of hours talking about what property types, geographies, risk buckets and capital structures present the most compelling opportunities, and also about when the market is likely to come back. But given this is only a 15-minute podcast, I invite everyone to download our house views report where we summarize all of this. Thanks, Margaret, and thanks, Maribel. As always, I've thoroughly enjoyed our conversation.

MM: [00:12:25] Likewise, Jeff. It's great to be here.

MY: [00:12:28] Always a pleasure to have you both on RPM. I've no doubt you two could easily go on for another two hours, but I do think you were able to cover a lot of ground from a high level. On that note, I'd like to thank our audience for listening and encourage them to reach out to a member of our team if they're interested in the full Fall 2023 House Views, replay of the house views webinar, or any other information. As a reminder, you can also visit us at www.stepstonegroup.com and RPM is available on Apple Podcasts, Spotify, Stitcher and other podcast platforms.