

WINTER
2025

NO ONE ELSE TO BLAME:
**WITHOUT DISTRIBUTIONS,
FUNDS CAN'T RAISE CAPITAL**

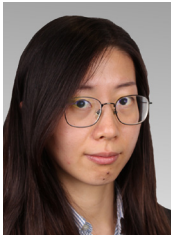




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Raising capital has proved a herculean task for private real estate funds in recent years, with fundraising taking longer and proceeds down sharply. This is true despite the substantial rise in interest rates that has created balance sheet challenges, in turn leading to potentially the most interesting distressed-investing opportunity in 15 years. So what’s the holdup? Of course, there are multiple factors at work. This article focuses on one in particular—liquidity.

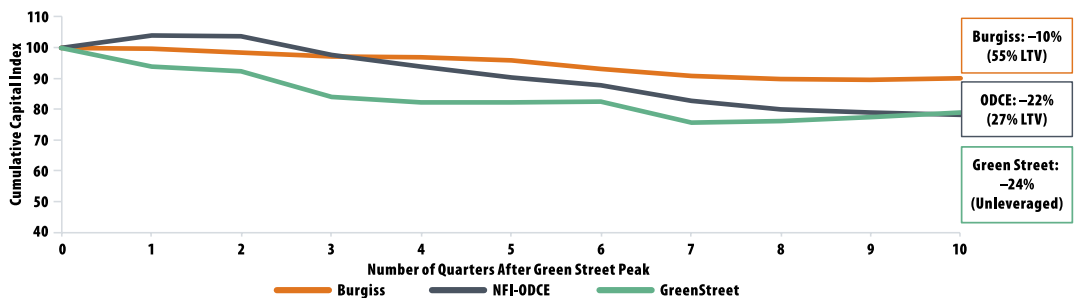
Our recent analysis of non-core real estate fund data shows a sustained drop in distributions, while capital calls are back to normal. This means that investment programs that were generating capital or self-funding now require funding, which can put the brakes on new commitments (and by the way, there can be spillover restrictions from a similar backup in other parts of the private investment portfolio). Distributions are down because managers are holding on to assets rather than selling, in hopes they can avoid losses and improve multiples with time and work as market conditions improve. A key factor in the decision to hold is carrying values that are still well above trading values. Our analysis shows that holding out for higher returns has historically not worked as desired in aggregate.

We looked at closed-end value-added and opportunistic real estate funds that we view collectively as non-core. This generally means funds with targeted returns of 12%–14% for value-added and 15% and higher for opportunistic, as distinct from the targeted returns of 6%–8% for core and 9%–11% for core-plus strategies.¹ Higher returns typically mean higher risk, with non-core funds predominantly comprising transitional assets or developments, with returns often fueled by high leverage. These characteristics have made non-core funds particularly vulnerable in the current environment.

Interest Rate Hikes Lead to Declining Values

Commercial real estate values started to decline when interest rates began rising in mid-2022. Green Street’s Commercial Property Price Index (CPPI) provides a good approximation of the value change, capturing prices at which institutional-quality real estate transactions are being negotiated and contracted. Peak to trough (1Q22–4Q23), Green Street’s CPPI dropped about 24%, led by declines in apartment and office. In aggregate, the index has stabilized and even ticked higher over the past year, now sitting 21% below the 2022 peak (Exhibit 1).

Exhibit 1: Private Real Estate Valuation, Fund Correction Lag

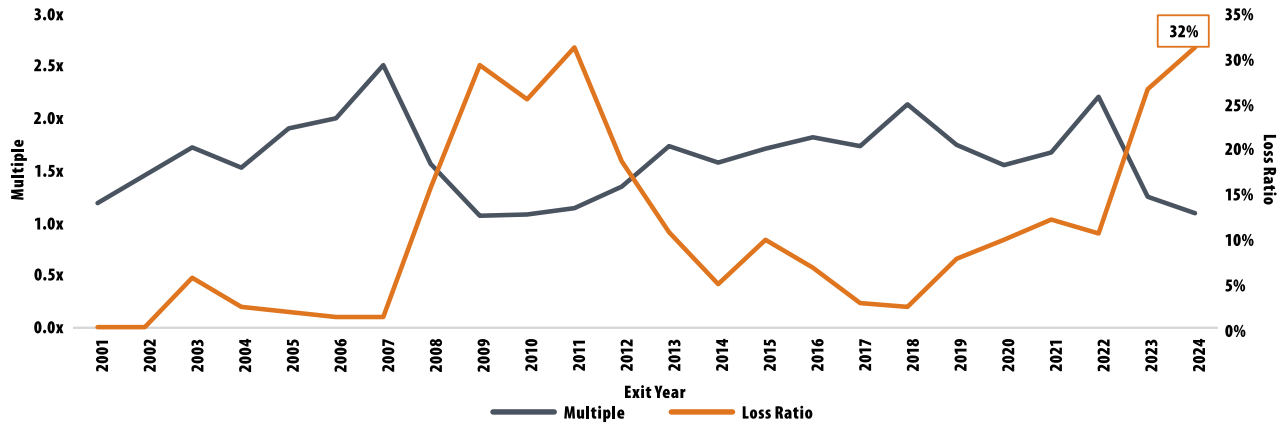


Sources: Green Street, NCREIF, Burgiss, SRE Calculation; January 2025

Note: The Green Street CPPI is weighted by NFI-ODCE property mix rather than the 25% equal weighting to major sectors in the published Green Street CPPI.

1. For illustrative purposes only. All information provided is at an industry level; no StepStone investments are included in any of the above metrics. All information provided here is based on research related to third-party managers. Target returns are hypothetical and are neither guaranteed nor predictions or projections of future performance. Future performance indications and financial market scenarios are no guarantee of current or future performance. There can be no assurance that such net target IRRs will be achieved or avoid substantial losses. Further information regarding net target IRR calculation is available upon request.

Exhibit 2: Realized Loss Ratio Surged in 2023 and 2024



Source: StepStone SPI Research and Reporting; January 2025

While adjusting downward, real estate fund valuations have lagged in part because of their appraisal-based, backward-looking nature. The capital appreciation component of the NCREIF Fund Index—Open End Diversified Core (NFI-ODCE) is down 22%—but on a leveraged basis, which suggests the drop versus the unleveraged CPPI should be much greater. Non-core fund valuations are even further behind, with the Burgiss VA/Opportunistic fund index down about 10% (Exhibit 1). Non-core funds are, on average, about 55% leveraged, so for the existing, unrealized portfolio, a drop in net asset value on the order of 50% (–24% loss in gross value on a base of 45% equity) would be expected.

It's difficult to pinpoint this value change for a diverse, dynamic index reported in terms of internal rate of return (IRR), but clearly there is a sizable valuation lag. Valuation reductions have been lowest for more recent vintages (2017 and subsequent). This is a somewhat counterintuitive outcome, likely to change over time, because these newer vintages experienced the most adverse impact from the changing circumstances. They bought during a higher-priced, lower-borrowing-rate environment and lack meaningful precorrection sales to anchor IRRs at higher levels.

Value Gap Weighs on Trading Volume

This spread between net asset values and trading prices has slowed transaction activity because a sale triggers the

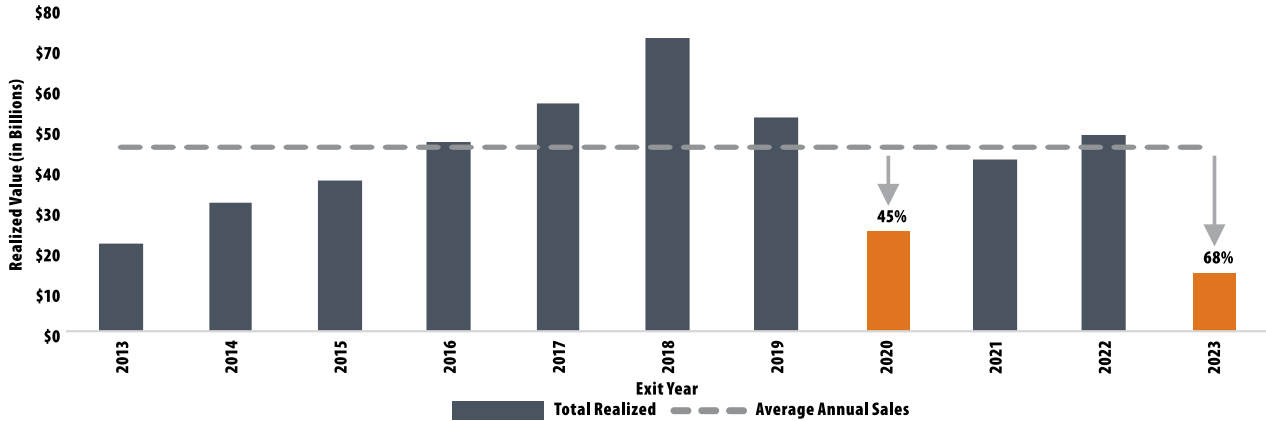
recognition of the full loss, which, as noted above, is a hit that should be closer to 50% than 10% at the asset level if an asset is 55% leveraged. A sale could also have implications for the values or perceived values of other assets in the funds with similar situations. Given that fact pattern, why sell if you don't have to? Overall, US transaction volumes appear to have bottomed out in 2023, rising nearly 10% year over year in 2024, but remain about 25% below the ten-year average.

Reinforcing the point on the valuation gap, realized loss ratios hit 32% for asset sales by non-core funds in 3Q24, the highest point since 2011 (Exhibit 2). Brokers report that most of what has been trading market-wide are the most desirable assets, which attract deeper bidding pools and have held their value better. This tends to mean smaller industrial assets (with shorter weighted average lease terms), certain retail assets, and residential, with the first two proving most resilient on pricing. So presumably, sales would lean heavily to these, plus forced sales, which are rising but have not yet hit expected levels.

Low Fund Sales Feed Liquidity Squeeze

Non-core fund asset sales fell far more than volumes in the overall market. In 2023, fund asset sale proceeds were nearly 70% below the ten-year average from 2013 to 2022 (excluding 2020) (Exhibit 3). The sharp decline in asset sales has translated to slower fund distributions. For the 12 months ending 3Q24, fund distributions were 66%

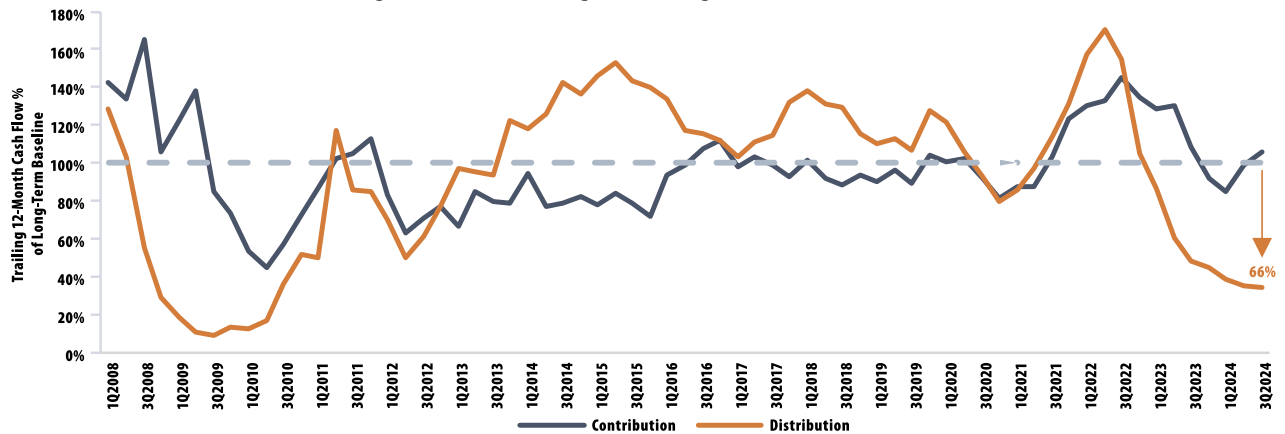
Exhibit 3: Annual Fund Asset Sale Proceeds Fell in 2020 and 2023



Source: StepStone SPI Research and Reporting; January 2025

Note: Because 3Q and 4Q asset sales data are still being collected and validated, the 2024 annual sales volume is considered preliminary and has been excluded from the chart.

Exhibit 4: Fund-Level Cash Flows, Trailing 12-Month Versus Long-Term Average



Source: StepStone SPI Research and Reporting; January 2025

below the long-term average (Exhibit 4). In addition to the prohibitive valuation gap, drivers of the outside drop in volume likely include the transitional nature of the assets, leverage issues, and an inclination to grow out of problems rather than recognize losses quickly.

Capital calls, meanwhile, have returned to long-term averages, driven in part by funding challenges (Exhibit 4). The surge in interest rates resulted in sizable funding gaps for non-core funds, which face greater challenges rightsizing their balance sheets because they started with higher leverage versus core and core-plus funds. They are also heavy users of shorter-term and floating-rate debt because it better matches their buy-fix-sell asset

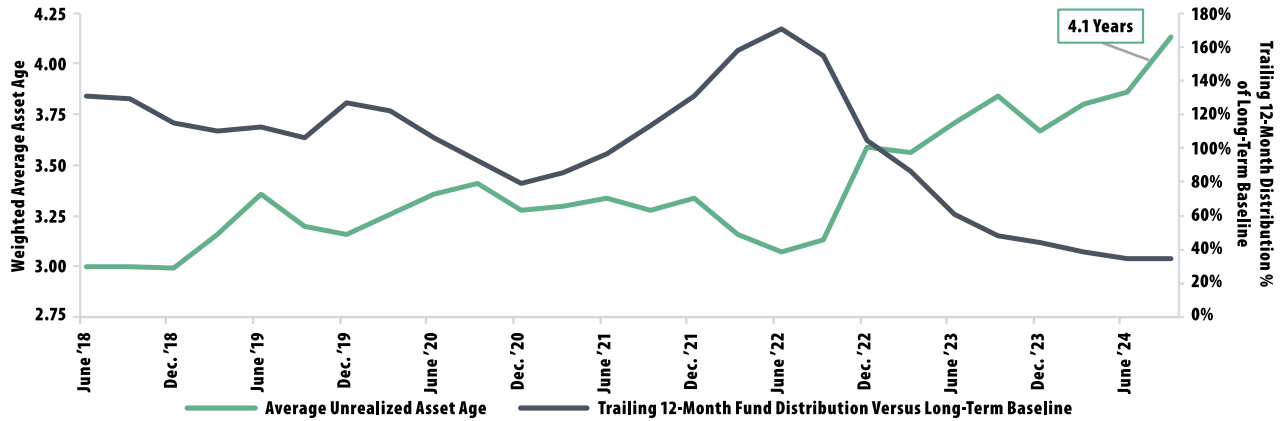
strategies. Longer holds with higher financing costs plus possible hits from deleveraging, inflated capital expenses, and slower leasing have many asset plans requiring quite a bit more capital than originally planned.

While new acquisitions have been occurring, unplanned investments in existing assets are likely making a big dent in dry powder. At year-end 2024, dry powder totaled about \$250 billion, 34% below year-end 2023 totals.

Funds Attempt to Delay Inevitable

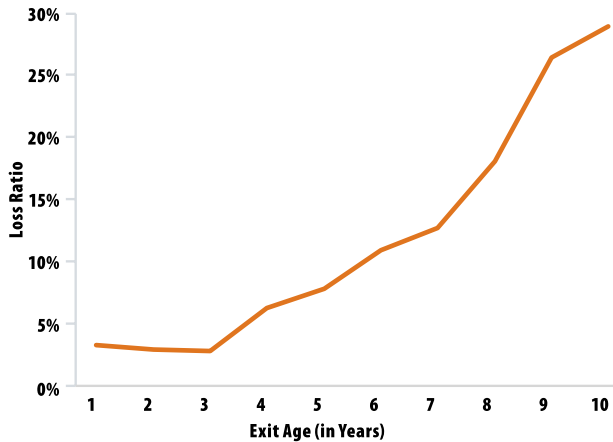
The drop in asset sales results in a larger pool of unrealized assets with higher average hold periods.

Exhibit 5: Average Age of Unrealized Assets Rises from 3.25 to 4.1 Years



Source: StepStone SPI Research and Reporting; January 2025

Exhibit 6: Exit Age and Loss Ratio



Source: StepStone SPI Research and Reporting; January 2025

Over the past two years, the average holding period for assets in closed-end funds went from 3.25 to 4.1 years (Exhibit 5) and could extend further. Not surprisingly, holding period lengths are cyclic. They peaked in the 2006–2007 vintages, which ultimately delivered the lowest returns of the last cycle. Assets purchased from 2020–2022 are well behind pace on sales already. Because they were likely bought at cyclic peak pricing and may be exited in a higher interest rate environment, those acquisitions have more risk of loss.

Problems can get bigger as funds attempt to wait it out. Loss ratios turn upward after year three and keep climbing with longer holds (Exhibit 6). Longer holding periods also

Exhibit 7: Bear Years Versus Others



Source: StepStone SPI Research and Reporting; January 2025

tend not to improve multiples. Looking at the “normal” non-global financial crisis vintages, multiples are very stable and essentially flat for holding periods of two and a half years and longer (Exhibit 7). A flat multiple, of course, means the IRR is going down as the holding period extends.

Crisis Begets Opportunity

The assets purchased just before the global financial crisis are different. Multiples precipitously declined through year five, as the crisis was reflected in both realized and unrealized values, and then lifted for assets held more than six years. However, it is critical to note that this was a period of declining interest rates, and



Meanwhile, more recent funds face a growing need to deploy dry powder before the end of their investment periods.

the longer the holding period, the more of this decline was reflected in exit caps. Effectively, “extend and pretend” did work then, mainly because interest rates fell. It would be difficult to extrapolate this lift to today’s challenged vintages without also assuming a large drop in long-term interest rates. Though not impossible, an array of macro factors is currently aligned against that.

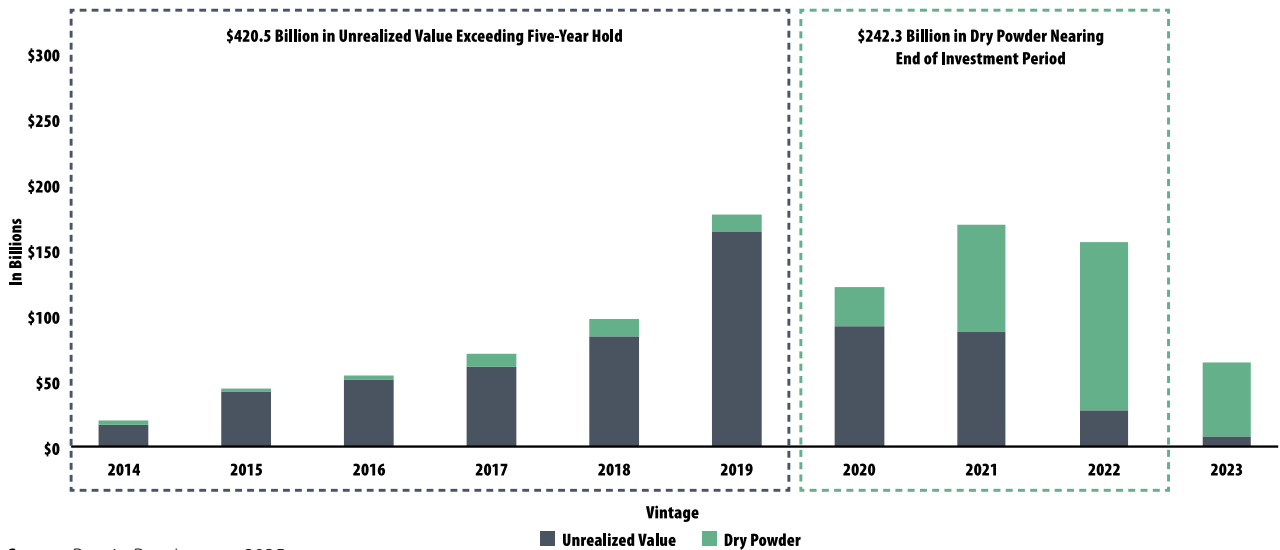
These years are also different because they generated disappointing returns, collectively doing little more than returning capital. However, their challenges were caused by factors that also set the scene for peak fund vintages around 2010–2011. Although this analysis is less promising with respect to outcomes for existing assets, the challenges may be setting the stage for another set of peak non-core vintages that investors that are able to manage their liquidity won’t want to miss.

Pressure to Transact

The data also show pressure building for both buyers and sellers to transact. The slow pace of asset sales has resulted in more than \$420 billion in unrealized value on assets that have been held longer than five years and are increasingly running into the end of agreed fund lives (Exhibit 8). Meanwhile, more recent funds face a growing need to deploy dry powder before the end of their investment periods. This pressure on both ends could lead to a narrowing of the bid-ask gap and a lift in both transaction activity and fund liquidity.

Factors other than liquidity may boost capital raising, most notably the reversal of the denominator effect. Given the stock market’s meteoric rise in recent years, most investors are now

Exhibit 8: Non-Core Fund Exposure by Vintage



Source: Prequin Pro; January 2025

underallocated to real estate. This takes some time to translate to higher deployment plans but, absent other factors, should support a rise in new commitments in 2025. On the other hand, as valuations of non-core funds descend to today’s reality, negative returns for the category may put off investors that are more focused in the rearview mirror or bad office headlines than the opportunity at hand. Some of that might have been at play in 2024.

Fundraising in 2024 was particularly slow. This is reflected in the average time from first to final close, which has almost doubled since 2019, moving from 12 to 23 months, including a jump of almost five months in 2024 versus 2023. Aggregate capital raised in 2024 was roughly half the 2021 peak amount and dropped 29% below the ten-year average.

Small and medium-sized managers are struggling more with fundraising because institutional investors are favoring larger managers. On average, larger funds (more than \$1.5 billion) have slightly shorter fundraising periods, and specific funds have much faster turns. For example, first to final close for Blackstone’s Real Estate Partners X and Starwood’s Distressed Opportunity Fund XII was just ten months. Larger funds also represent an outsize share of total

capital raised. Although larger funds represent less than 5% of total funds in the market, they’ve raised 44% of total non-core capital since 2017. ■

Note: Unless otherwise cited as from Burgiss or NCREIF, above data are from SPI by StepStone, a proprietary database that tracks more than 3,750 real estate managers and 8,650 funds. In addition, the work is informed by the on-the-ground insights of our global investment and advisory teams, with total capital responsibility for \$184 billion.

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