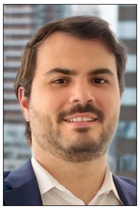
Valuation Enigma: Beyond the Bid-Ask Spread



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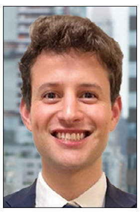

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The rapid rise in interest rates since March of last year has left the commercial real estate transaction market in a state of near paralysis across most sectors and geographies. Uncertainty (or disagreement) about valuation persists, with owners reluctant to adjust to the reality of the new environment and buyers demanding higher unleveraged returns, in part driven by the substantially higher cost of debt. Globally, commercial real estate transaction volume for the fourth quarter of 2022 was down 60% year over year.[1] Multifamily had the largest decrease at 72%, and hospitality had the smallest decrease at 20%, which seems consistent with the theme that the market's paralysis is valuation driven. Multifamily had record transaction volume and historically low cap rates in 2021, and the hospitality sector remained far more measured coming out of the COVID-19 pandemic.

The industry today, though, is increasingly driven by activity beyond typical arm's-length property sales between buyers and sellers, creating a more complicated picture of value. More specifically, there has been a proliferation of investment structures that are driven by assessments of value that are hypothetical in nature. Two prime examples are open-end funds and secondary transactions. Both generally involve the use of appraisers and/or valuation consultants, who in turn typically rely on comparable arm's-length transactions to derive their assumptions and calculate value. Given the dearth of such transactions, valuation consultants have been slow to update their assumptions, which is having a knock-on effect, spreading market paralysis into other corners of the real estate private equity market. But with the scale and significance that these corners of the industry now occupy, we wonder if the proverbial tail is wagging the dog.

Open-End Funds

Although quarterly valuations for open-end funds certainly don't constitute transaction activity, capital flows in and out of these funds have widespread implications for the industry at large given their scale, and valuation plays a meaningful part in driving open-end fund capital flows.

The universe of open-end funds has expanded dramatically since the global financial crisis. In the US, the open-end diversified core equity (ODCE) fund market has approximately doubled in size, and there's been a new wave of sector- and strategy-specific open-end funds. In Europe, their scale is even more meaningful as a percentage of the overall European market. The European Central Bank has indicated that eurozone real estate funds had assets under management (AUM) of approximately €1.04 trillion (approximately $1.14 trillion), more than five times the €200 billion of eurozone real estate fund AUM in 2007.[2] Approximately 40% of commercial property in the eurozone is held in funds, doubling over the past decade, and approximately 80% of these funds by value are open-end.[3]

Elevated redemption queues in open-end funds have been grabbing headlines. The redemption queue for ODCE funds totaled $20 billion as of year-end 2022, the largest amount since the global financial crisis.[4] However, we aren't ringing the alarm bells quite yet. For one, the $20 billion redemption queue represents approximately 7% of total net asset value for the index, compared to a 15% rate during the financial crisis.[5] We also think that a substantial amount of redemption requests may ultimately be rescinded by investors rather than fulfilled by managers and that the race to the redemption door has been driven, in large part, by inflated valuations.

As of the end of the first quarter, the average cap rate for the NCREIF Property Index (NPI) was 4.19%,

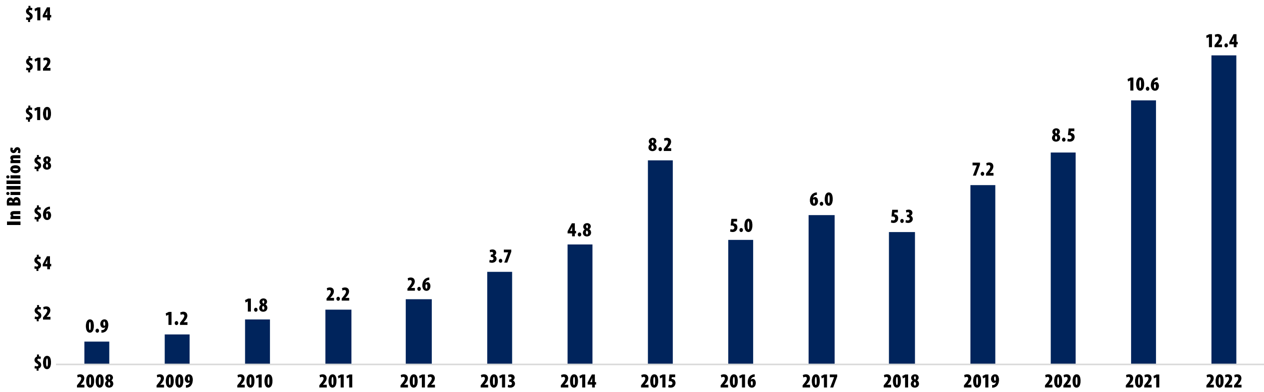
1. CBRE Research and Real Capital Analytics, 4Q2022.
2. Pierce Daly, et al., "The Growing Role of Investment Funds in Euro Area Real Estate Markets: Risks and Policy Considerations," European Central Bank, April 3, 2023.
3. Daly, "The Growing Role of Investment Funds."
4. John Gittelsohn, "Investors Seek to Pull $20 Billion from Core Real Estate Funds," Bloomberg, Jan. 17, 2023.
5. Gittelsohn, "Investors Seek to Pull."

Exhibit 1: NPI Implied Cap Rates

NCREIF Property Index	4Q2021	1Q2022	2Q2022	3Q2022	4Q2022	1Q2023
Average Implied Cap Rate	3.83%	3.71%	3.73%	3.82%	4.03%	4.19%

Source: NCREIF

Exhibit 2: Real Estate Secondary Trading Volume



Source: Ares Secondaries, Company Release, Feb. 2023

up less than 50 basis points from its low of 3.71% in 1Q2022 (Exhibit 1). Interestingly, NCREIF pointed out for the most recent quarter that the average cap rate for properties that actually sold during the period was significantly higher at 5.61%, a data point not usually included in the quarterly release.

Of course, the NCREIF Property Index includes more than just ODCE fund assets, and the assets sold in the most recent quarter could very well have been concentrated in one property type or bad performers among other reasons for higher cap rates. Still, it paints the picture for what we believe is a driving force for limited partners' (LPs') submitting redemption requests as they try to rightsize their real estate allocations. Redeeming shares in a liquid fund at a price that's a third more than the assets would sell in the "open market" might be called an arbitrage opportunity.

This dynamic puts managers in a challenging position. The new iteration of open-end funds gives managers far more discretion about how and when to satisfy redemption requests, and we believe managers will be slow to create liquidity rather than sell assets at prices that are below current marks. Once open-end fund valuations begin to catch up with the market, investors will find redemptions to be less attractive and their overall real estate portfolios will have also generally decreased in value, bringing their allocations more in line with targets and alleviating the need to create liquidity.

Until then, however, open-end funds will be starved for liquidity. StepStone Real Estate pointed out in its "House Views" webinar in April that entry into core and core-plus open-end funds should be delayed until net asset values more accurately reflect the current interest rate environment. With minimal new capital expected to be allocated toward these funds and any such capital likely being used to satisfy redemptions, open-end funds will likely be on the sidelines in respect to new acquisitions. Stubbornly high marks are likely to impact the transaction market in a less obvious way than a bid-ask spread—namely, by removing open-end funds from the transaction market as either sellers or buyers.

Secondaries

While not nearly of the same scale as the open-end fund universe, the secondaries market in private real estate has grown by more than five times since the financial crisis, including a 16% compound annual growth rate (CAGR) over the past five years, with total 2022 transaction volume estimated to be more than $12 billion of net asset value (Exhibit 2).[6] That growth,

6. Ares Secondaries, Company Release, Feb. 21, 2023.

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especially recently, has been driven primarily by general partner (GP)–led secondaries, generally in the form of portfolio recapitalizations or "continuation funds." This segment of the market has grown by a 46% CAGR over the past five years and comprised 77% of total real estate secondaries volume in 2022. There are myriad reasons a manager would want to pursue a continuation fund, and so though the scale of transaction volume is a much smaller order of magnitude compared with the open-end fund market or with overall transaction volume, disruption in this segment of the market has the potential to create an outsized impact on managers.

In 2021 and the first half of 2022, managers were interested in pursuing GP-led secondaries, and they had a meaningful (albeit still measured) success rate of execution. Continuation funds became commonplace in the lexicon of managers when discussing how they might create a realization for a fund. But since the second half of 2022, many of these plans were shelved. A key element of executing such a transaction is getting sign-off from the existing investors on pricing. LPs tend to be price takers rather than price makers in these instances and generally rely on a third party to help ascribe value, given the inherent conflict managers face. In a liquid sales market with deep pools of bidders, a third party could point to a fair price fairly easily. Now, with fair value ascribed by a third party likely still inflated, attracting new investors to execute the transaction will be challenging, and a manager will have a hard time explaining to existing investors why affiliate transactions were executed at pricing lower than the investors' latest marks or what the valuer indicated without running a fully marketed process.

Without a potential GP-led secondary as part of the equation, a manager might be more likely to test the sales market. Although pricing may have deteriorated from 12 months ago, the time value of money certainly weighs on a manager's promote, and there could always be the needle-in-the-haystack buyer that surprises to the upside. But now, in search of the holy continuation fund grail, managers are more inclined to keep portfolios intact and wait until the market stabilizes and when an agreement on value between existing and new investors might be easier to facilitate. The likely result is a smaller pool of potential sellers.

Conclusion

Given the outsized impact valuers and appraisers have on the health and operation of the private real estate sector, should they consider a more a priori methodology rather than just a reaction to the sales market? With benchmark interest rates up 400 to 500 basis points and credit spreads wider as well, a scholar of finance might deduce that cap rates should be up more than 50 or even 100 basis points.

Expecting private markets pricing to adjust to current conditions with the pace of more liquid financial markets is hard. Indeed, one reason investors find private markets attractive is the opacity, which arguably provides the opportunity to generate alpha, particularly in times of uncertainty or dislocation. And at a more pragmatic (or even cynical) level, the incentive structures from the perspectives of both GPs and LPs favor a more moderate approach to valuation updates, with both sets of constituents generally wanting a stable, low-volatility investment product with minimal impact from market gyrations. Still, even a slightly higher propensity to make educated updates to valuation assumptions could facilitate a sooner return to normalcy, whatever that may mean today. ■

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