How Real Estate Investors Are Reacting to Recent Market Dynamics

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The Institutional Real Estate Allocations Monitor survey, jointly conducted by Hodes Weill & Associates and Cornell University's Baker Program in Real Estate, was launched a decade ago to address a frequently asked question from global institutional investors: "What is the typical target allocation to real estate in institutional portfolios?" The Allocations Monitor has expanded over the years and captures investors' latest portfolio allocations to real estate, current and future investments, conviction level, investment management trends, and the role of various investment strategies and vehicles within the context of real estate allocations.

The latest Allocations Monitor arrives at a time of dislocation and transition in the global capital markets. The key findings of the 2022 Allocations Monitor point to a slowing of institutional capital deployment into real estate because of strong prior portfolio returns combined with the denominator effect, which have contributed to overallocation in institutional portfolios. However, target allocations continue to increase in anticipation of attractive buying opportunities over the next 12 to 24 months, underscoring the importance of the asset class in institutional portfolios.

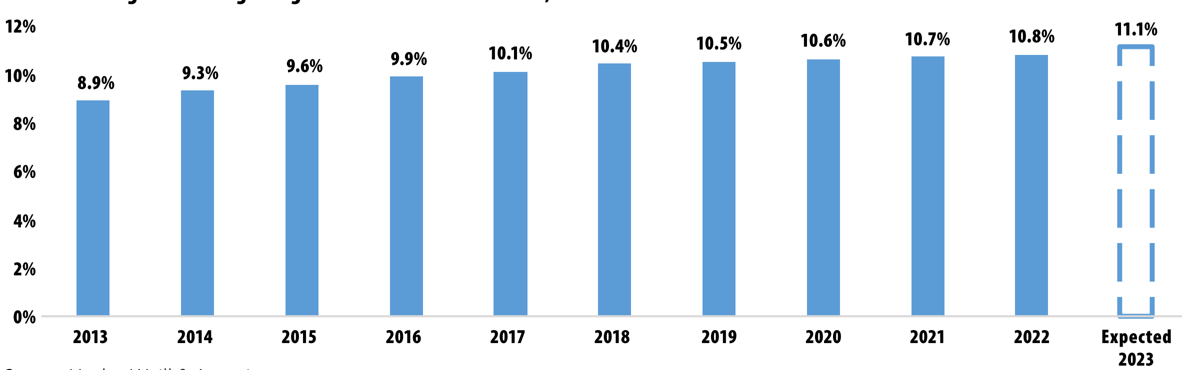
The research was collected on a blind basis from 173 institutional investors in 34 countries across Asia-Pacific (APAC), the Americas, and Europe, the Middle East, and Africa (EMEA). These institutions manage a total of more than US$11.0 trillion in assets under management (AUM) and have real estate allocations of approximately $1.1 trillion. This large segment of the market provides interesting and thought-provoking perspectives for participants in the real estate investment industry.

From Alternative to Essential—The Pie Is Still Growing

Real estate as an asset class has been playing an increasingly important role in institutional portfolios in recent years, as evidenced by nine straight years of increases in portfolio allocations since 2013, as shown in Exhibit 1. Institutions reported an average target allocation of 10.8% to real estate in 2022. The 10 basis point (bp) increase from the prior year implies a potential addition of $80 to $120 billion of capital allocations to real estate over the coming years.[1] On an absolute value basis, global real estate AUM reached €4.1 trillion (approximately US$4.4 billion) in 2021, more than triple that of a decade ago, according to the 2022 ANREV, INREV, NCREIF Fund Manager Survey.

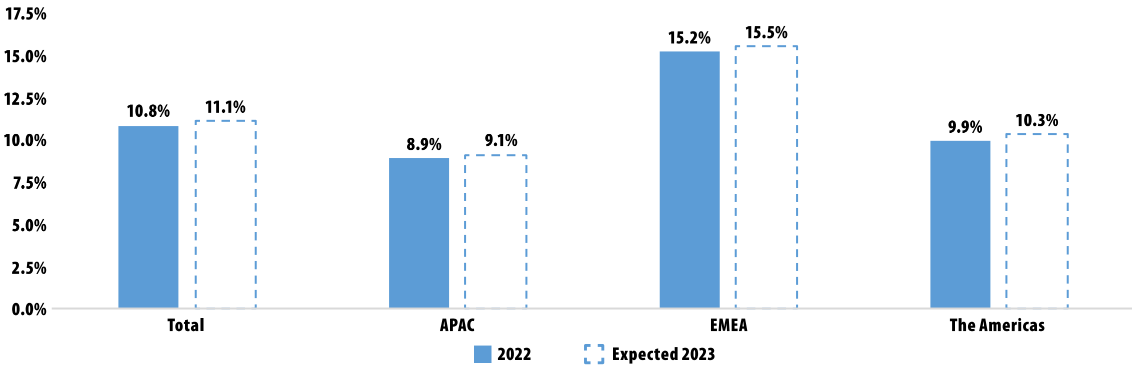
1. Hodes Weill's estimate of ±US$100 trillion of global AUM based on various public disclosures, research reports, and publications.

Exhibit 1: Weighted Average Target Allocation to Real Estate, All Institutions



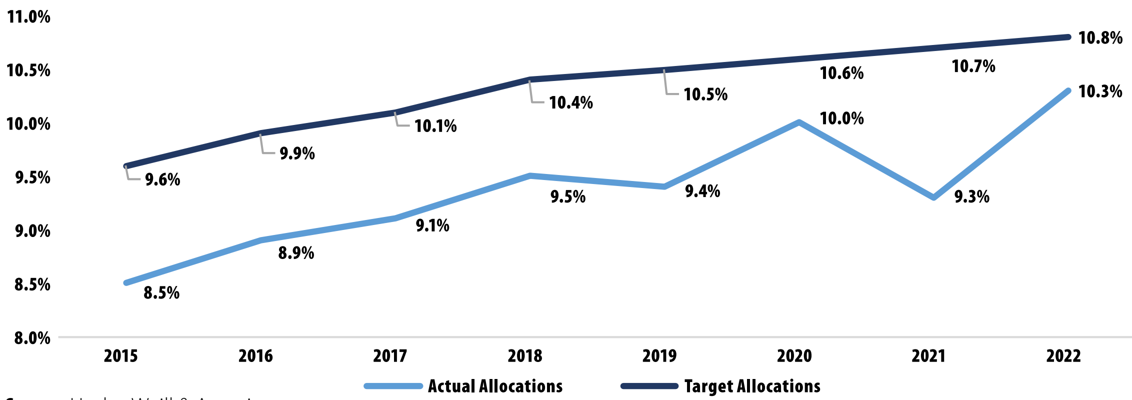
Source: Hodes Weill & Associates

Exhibit 2: Weighted Average Target Allocation by Location of Institution



Source: Hodes Weill & Associates

Exhibit 3: Actual Versus Target Allocations, 2015–2022



Source: Hodes Weill & Associates

Real estate is expected to play an even more important role in portfolios for the next 12 months, with a forecast increase in allocation of 30 bps to 11.1% (Exhibit 2). It is also worth noting that the expected increase is consistent across different regions. Similar to prior years, EMEA investors are leading the allocation to the asset class, followed by their counterparts in the Americas and APAC.

Sentiment May Have Changed, Not Necessarily the Underlying Fundamentals

In our article for the Winter 2020 *PREA Quarterly*, we identified that real estate portfolios are exposed to certain risks, such as rising interest rates. However, few people anticipated the degree and speed at which interest rates would rise over the past year. As a result, investors significantly slowed their deployment pacing to real estate. Institutions on average were still reporting under-allocations in the 2022 survey, but the 50 bps gap between actual and target was the smallest margin over the past eight years, as shown in Exhibit 3. Notably, the reported increase in actual allocations was driven by a combination of both denominator and numerator effects. While public equities and other asset classes declined in value, real estate portfolios benefited from strong performance with high returns and resilient valuations.

The Allocations Monitor includes a Conviction Index that tracks sentiment toward the asset class on a scale of 1 to 10. As shown in Exhibit 4, the 2022 results indicate a 0.5 point decline in conviction, following four consecutive years of increase. The decrease in conviction is not entirely surprising, given the many uncertainties the global economy faces, including high inflation, geopolitical tensions, rising interest rates, and fears of a

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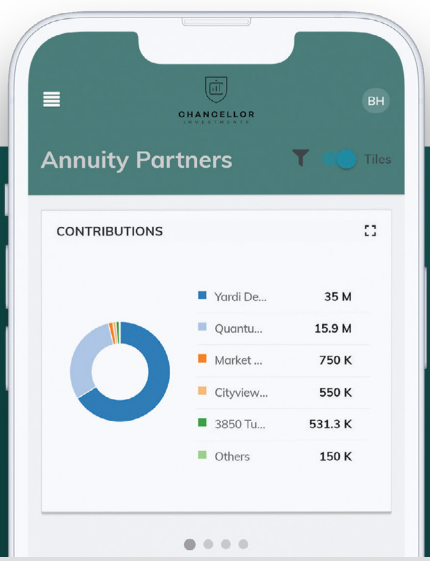

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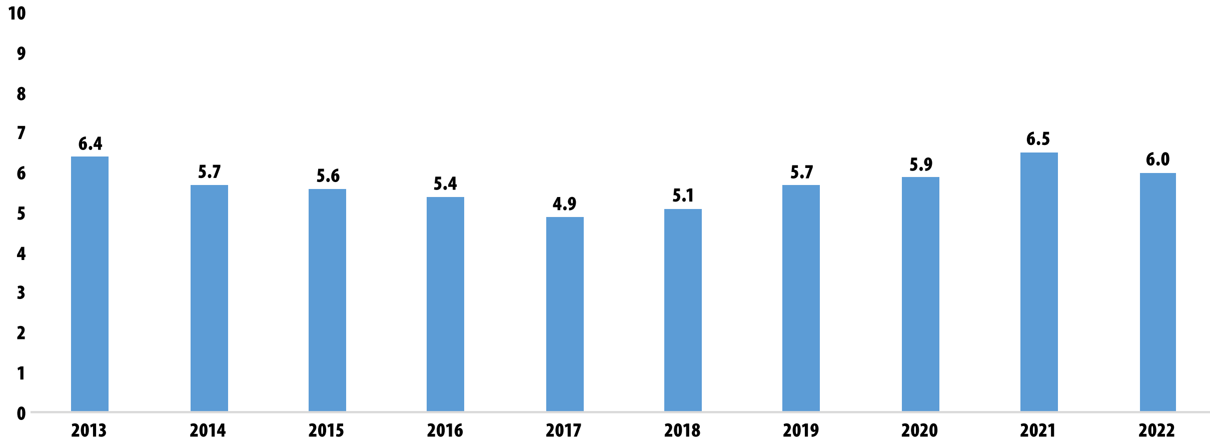
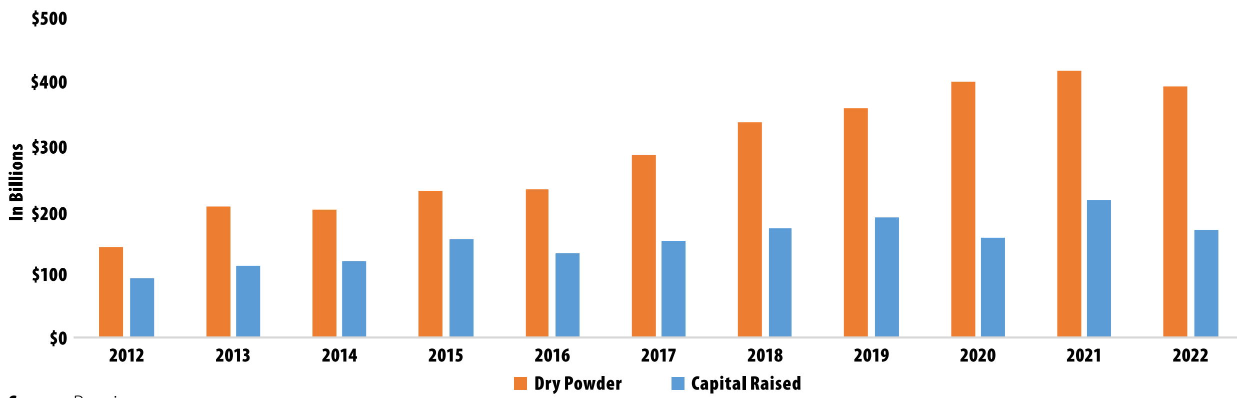
Exhibit 4: Conviction Index, All Institutions



Source: Hodes Weill & Associates

Exhibit 5: Dry Powder and Capital Raised



Source: Preqin

global recession. Investors are anticipating that portfolio allocations will rebalance as a result of anticipated write-downs in real estate and other private market portfolio values over the coming quarters. Institutions are likely to exercise restraint until they have more clarity regarding actual investment levels.

Despite the recent shifts in sentiment, the 2022 Allocations Monitor underscores that real estate's actual performance has been impressive: one-year, three-year, and five-year actual returns reported at 17.1%, 10.5%, and 9.9%, respectively, all exceeding institutions' average target of 8.2%. These were bolstered by strong transaction volumes and liquidity, positive operating fundamentals, and rental growth as the markets opened back up following the COVID-19 pandemic, along with plentiful debt at an accretive cost of capital. Although institutions are anticipating some turbulence over the upcoming quarters, much of the diminution in value is expected to be attributed to a shift in cap rates and borrowing costs, some of which may be offset by the continued strength in demand and rents.

Attractive Investment Opportunities Could Emerge In the Next 12–24 Months

When asked to compare the current market environment with the global financial crisis, Allocations Monitor participants, on a positive note, believe the industry is better positioned today. Real estate was the "problem child" heading into the financial crisis, with slowing demand trends, overbuilding, and excess levels of leverage. In contrast, though the property markets are currently repricing, operating fundamentals remain stable to strong, and leverage levels are more moderate. Moreover, leverage is also supported by higher-quality borrowers. The rapid increase in interest rates, though adding to complexity in financing and underwriting, also contributes to an expected reset in valuations that could result in attractive acquisition opportunities. Conviction remains high for real estate assets that are driven by long-term demographic and secular tailwinds, such as industrial/logistics, multi- and single-family rentals, life sciences and lab space, data centers, self-storage, and other nontraditional asset sectors.

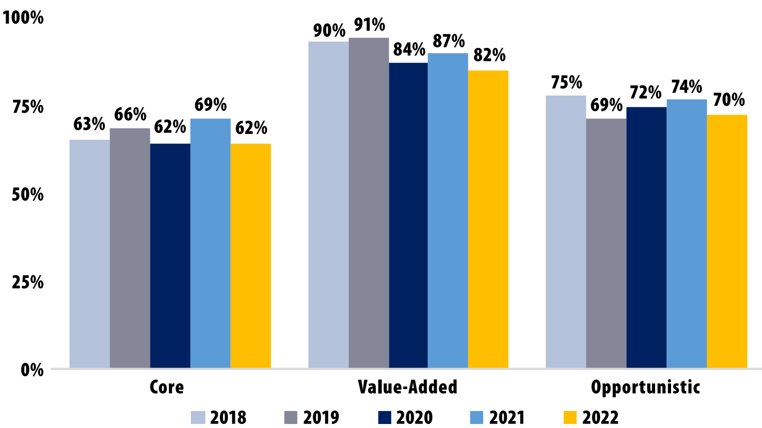
From a capital standpoint, there is still abundant dry powder in the market, with $390 billion ready to be deployed as of year-end 2022, one of the highest levels in recent years, as shown in Exhibit 5. With continued increases in their allocations to real estate, institutions are closely monitoring attractive investment opportunities that may emerge over the next 12 to 24 months. For many, if the distress and dislocation that was expected to follow COVID-19 in 2020 instead begins to materialize in 2023 and 2024, the next several years may prove to be good vintages for capital deployment.

Understanding Investors' Preferences Is More Critical Than Ever

Fundraising activities slowed significantly in 2022, with the number of funds closed declining to 391 from 596 in 2021. Fundraising timelines expanded to an average of 21 months (20 in 2021, 11 in 2007), according to Preqin. Amid volatile market conditions, investors appear to be finding comfort in familiarity. Institutions continue to favor allocating capital to existing managers, with only 31% of them expecting to build new manager relationships. In the meantime, top ten real estate managers reported a 41.6% year-over-year increase in AUM in 2021, substantially outperforming the industry average of 24.2%, according to the ANREV, INREV, NCREIF Fund Manager Survey. Understanding investors' preferences and strategies is critical in the competition for capital.

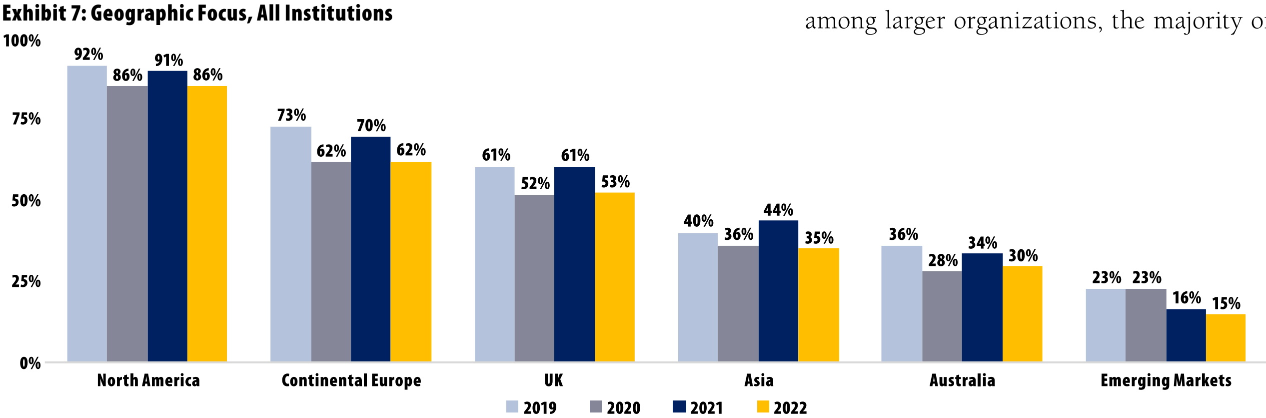
Notwithstanding the continued trend to internalize portfolio management, especially among larger organizations, the majority of

Exhibit 6: Risk Preference, All Institutions



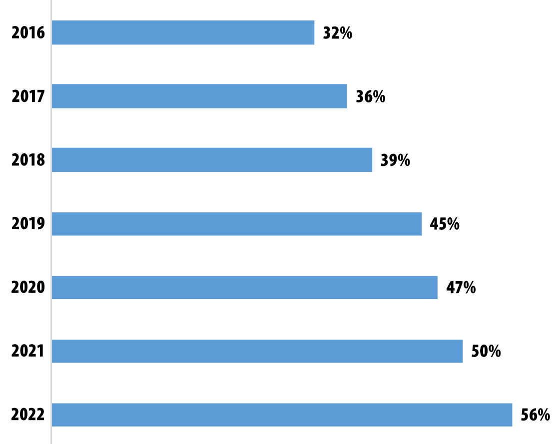
Source: Hodes Weill & Associates

Exhibit 7: Geographic Focus, All Institutions



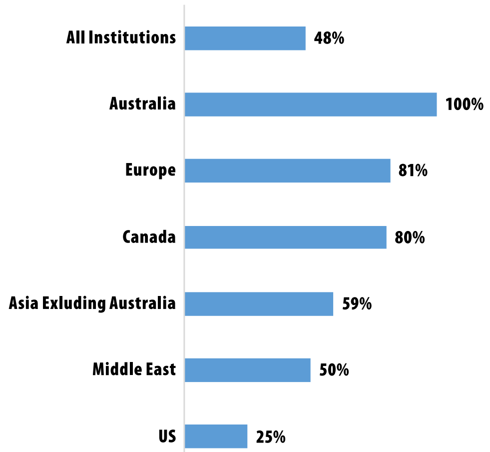
Source: Hodes Weill & Associates

Exhibit 8: Formal ESG Polices, 2016–2022



Source: Hodes Weill & Associates

Exhibit 9: Investment Process Influenced by ESG Policies by Location of Institution



Source: Hodes Weill & Associates

institutions continue to rely on the expertise of third-party managers to access the asset class. Overall, 96% of institutions reported outsourcing their portfolios to third-party managers, either entirely (62%) or partially (34%). In terms of investment format, commingled funds remain the most popular product, yet larger, well-resourced institutions are more inclined to retain discretion in joint ventures and separate accounts or pursue direct investments.

Although appetite declined across the risk spectrum because of a more cautious investment approach, value-added and opportunistic strategies remain the most favored strategies among institutional investors, as shown in Exhibit 6. Investors continue to demonstrate appetite for higher returns, anticipating a compelling opportunity over the next several years to take advantage of potential distress and repricing. In contrast, with the current interest rate environment creating challenging conditions for core investments, a decreased appetite for core strategies is not a surprise. In terms of target destination, there hasn't been substantial change year over year, with North America remaining the most preferred market, followed by Europe.

ESG Continues to Be a Growing Focus

The importance of environmental sustainability, social responsibility, and governance (ESG) continues to shape institutions' investment decisions, management, and product offerings. Exhibits 8 and 9 show a steady trend of ESG being formalized into institutions' investment decision processes: 56% of institutions now have formal ESG policies in place, with Australian, European, and Canadian investors leading the charge.

Conclusion

As we begin 2023, institutional investors once again face an uncertain capital markets environment. However, despite denominator issues and market uncertainty, we expect real estate allocations to increase for many institutions, in recognition of the important role of the asset class in their portfolios and in anticipation of attractive vintage years for investing that lie ahead. ■

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