Rationalizing Real Estate

by | **David Twist**

Poor relative performance in recent years has left many institutional investors underallocated to real estate. The author contends that it may be a good time for pension funds to reevaluate their real estate investments as transaction activity increases and markets continue to recover.

Real estate is a well-understood alternative investment, and investment in real estate is commonplace among modern retirement plans. It offers both diversification and a partial inflation hedge, but falling values have frustrated investors in recent years.

As bad or worse, many open-end real estate funds (those that do not have a termination date) that tout liquidity as a key feature have been providing little or no liquidity to investors wishing to make redemptions. This is problematic when investors depend on redemptions to raise cash.

Falling interest rates and rising transaction activity have contributed to an improvement in the performance of real estate investments and their liquidity. But the sector faces competition from newer alternative asset classes such as private debt and infrastructure. These may compete with real estate for a place within the allocations that institutional portfolios make to alternative investments.[1]

Now may be an especially impactful time for pension funds to rethink, rationalize and adapt their real estate investments. This article will describe the attributes of private real estate equity investments, discuss how they are valued and offer considerations for pension funds evaluating their real estate allocations.

TABLE

Commingled Fund Types

	Core	Noncore
Subcategories	Core, core plus	Value-added, opportunistic
Risk/Return	Lower	Higher
Focus	Fully stabilized, income-producing properties	More risk, e.g. leasing, financing, renovation, redevelopment, etc.
Investment Term	Either evergreen/open-end or closed-end/drawdown-style	Almost always closed-end/drawdown-style

takeaways

- Institutional investors have been frustrated with the performance of real estate investments in recent years as values have fallen and liquidity has decreased.
- The fundamental appeal of investing in real estate is the opportunity for diversification and the partial inflation hedge it provides. Investing in real estate also provides current income and capital appreciation for investors.
- Many real estate funds are diversifying beyond traditional sectors, such as office, industrial, apartments and retail, into "alternative" real estate sectors such as medical and lab/life sciences offices, single family homes for rent, student and senior housing, data centers and self-storage.
- Real estate fundamentals remain healthy outside of the office sector. The scope of future demand for offices remains in question, and repricing of some office segments could take years to play out.
- As asset values increase and transaction activity picks up, pension funds may want to reevaluate their real estate allocation and redemption requests.

Real Estate Is Both Equity- and Debtlike

The fundamental appeal of investing in real estate includes the following.

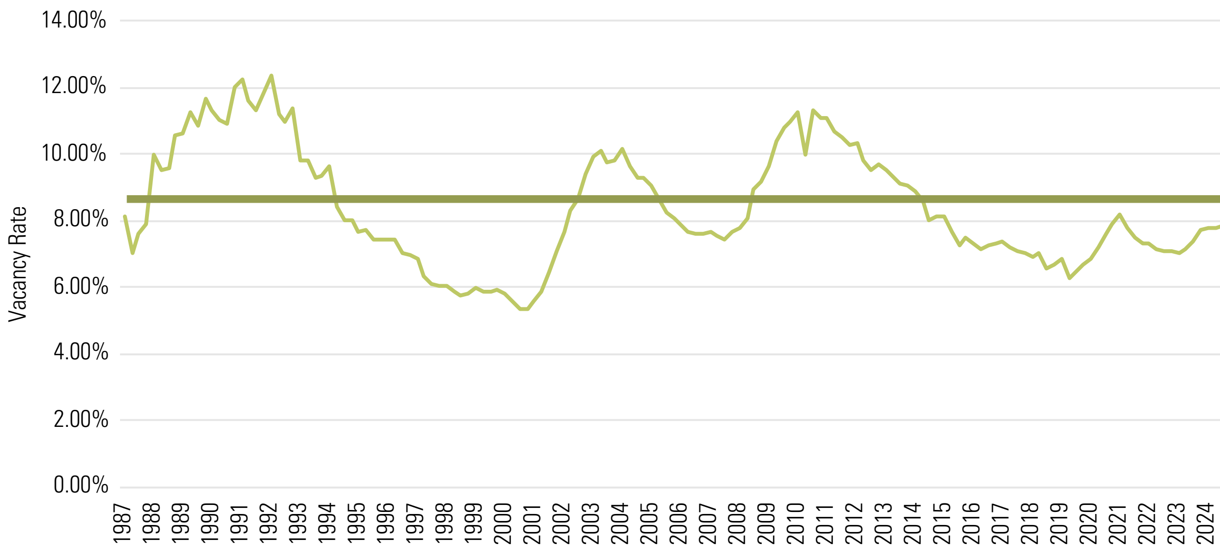
- It diversifies the traditional equity/bond mix in institutional portfolios.
- It provides a partial inflation hedge.

An investment in real estate provides both current income and capital appreciation for investors, detailed below.

- The income component of real estate comes from the cash flow generated by contractual leases.
  - –Some sectors offer income that is short term, (e.g., multifamily residential properties).
  - –Income in other sectors (e.g., commercial and warehouse properties) is typically multiyear where leases are often with leading or growing businesses.
- Many of these leases contain *inflation escalators*, which are provisions that allow the lease terms to be adjusted with rising inflation.
- Real estate price appreciation is also (somewhat) inflation protected, since it is related to the replacement cost to assemble, build and lease the underlying property. When the prices of land, labor and/or materials go up, so should rent and the value of the property.
- Market prices depend on the factors above, as well as the cost of capital, investor sentiment and the relative attractiveness of other investment alternatives.

FIGURE 1

Real Estate Vacancy Rates: 1987-2024



Source: National Council of Real Estate Investment Fiduciaries (NCREIF).

Institutional Real Estate Equity Investing

Though some large institutional portfolios prefer to own (and in some cases develop) a portfolio of their own properties, building a diversified portfolio using that approach requires significant time, capital and expertise. Instead, most invest through commingled funds that have a diverse portfolio of many properties. These commingled funds can be public (real estate investment trusts (REITs)/operating companies) or private (private REITs/limited partnerships). This article will address trends in private real estate investing.

Commingled funds are usually categorized by strategy type along two buckets: "core" and "noncore," described in the table on page 38.

Many investors use the National Council of Real Estate Investment Fiduciaries (NCREIF) Index of Open End Diversified Core Equity (NFI-ODCE) Funds to evaluate the performance of core real estate investments. It consists of 25 open-ended funds[2] that are diversified by property type and geography, offer quarterly "liquidity" and have conservative limits on their use of leverage.

There are other indexes for private real estate investments, but the NFI-ODCE index is the primary index for core open-end funds, and it has been in existence since 1978.

NCREIF requires NFI-ODCE funds to have their assets externally appraised every quarter. This sets the value of the individual properties, which then combines to create the net asset value (NAV) of the fund. That is the price at which investors buy and sell "shares" of the fund.

Many institutional investors use NFI-ODCE funds because they:

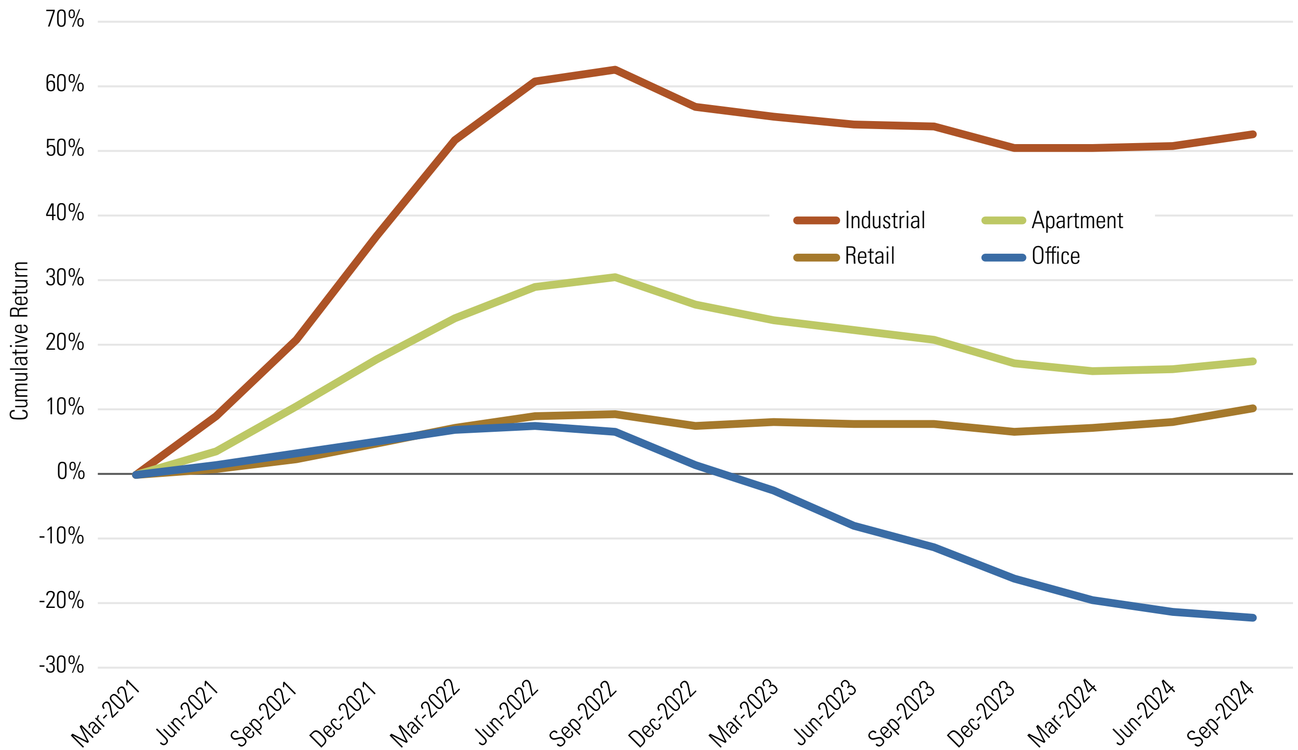
- Are relatively transparent (for purposes of appraisal)
- Have large, diversified portfolios of core assets
- Provide some liquidity mechanism.

Changing Views on Real Estate Sectors

To ensure a diversified index, NCREIF requires participating funds to invest in at least three of the four traditional property types (apartment, industrial, office and retail). Yet given the decades-long fear of the "death of retail" due to online retailers and the more recent challenges facing remote work and office buildings (office), many funds are diversifying into "alternative" real estate sectors or even infrastructure-style investments in order to move away from retail and still remain diversified.[3] These alternatives include medical and lab/life sciences offices, single-family homes for rent, student and senior housing, data centers and self-storage. The housing-

FIGURE 2

Performance by Property Type



Note: Property type data is delayed by one quarter.
Source: National Council of Real Estate Investment Fiduciaries (NCREIF).

related categories, including apartments, are often aggregated into "residential."

Questions about the future of the office sector and its potential recovery are beyond the scope of this discussion—however, it is an important one. Office is not "dead." It has always been the most cyclical of the major property types. The scope of future demand is very much in question, and the repricing of certain segments of office could take years to play out.

Figure 1 illustrates that real estate fundamentals (vacancy rates) remain healthy by historical standards, with industrial and multifamily properties realizing moderate increases. This has led to a flattening in rent growth in those property types; however, it is not declining rapidly as it did during most previous real estate downturns. The office sector remains challenged, and Figure 2 shows that while apartment, retail and industrial returns may have turned a corner, office may still be searching for a bottom.

Interpreting Real Estate's Recent Underperformance

The spike in interest rates in 2022 and 2023 caused disruption in the real estate lending and transaction markets. As rates rose, appraisers began raising the required rate of return (financing/cost of capital) of many core assets, causing their appraised values to fall. Lacking adequate transac-

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tional data, appraisers increased rates inconsistently across assets, submarkets, markets, property types and funds. The erratic timing and size of the fall in values resulted in problematic performance reporting. Investors became frustrated with unreliable values stemming from the appraisal process.

With values falling, investors attempted to redeem from many of the NFI-ODCE funds, causing many funds to partially or fully gate[4] redemptions (i.e., investors received only a portion of their requested cash-out). As a result, investors suffered through both falling values and receiving little or none of the promised liquidity.

The decline in value was likely a result of the appraisers' obscured view of capital markets at the time rather than oversupply and falling net income. The fundamentals of real estate remained attractive. It typically takes longer for the dust to settle for assets like real estate that are both illiquid and difficult to value, so investors would be well-served by focusing on their long-term targets during periods of stress.

bio

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Where Are We Today?

Transaction activity has picked up since the end of 2023, buoyed by stabilizing interest rates, increased availability of real estate credit, and narrowing of the gap between asking prices and offers from potential buyers. This increased transaction activity has helped the appraisal process. Asset values are flattening and, in some cases, beginning to increase. These changes are fueling real estate investment (and lending) and its ongoing recovery cycle.

On the investor side, the poor performance in recent years has left many investors underallocated to real estate. While many investors wait for managers to fill their sell requests (referred to as being in a "redemption queue"), they are at a crossroads where not all the redemption requests may need to remain in place. Furthermore, history shows that once values begin to rise, redemption queues often vanish.

Investors should actively evaluate their redemption requests and consider the following.

- How much real estate their portfolios should hold
- Which of the existing investments should be reduced or increased
- Their ongoing liquidity needs and tolerance for open-end versus closed-end funds
- Where they should allocate to maximize risk-adjusted return

With transactional activity rising and more consistency in the current appraisal process, some fund and asset values have begun to turn the corner, leading many to believe that a broad real estate recovery is at hand.[5]

Since real estate performed well in prior economic recoveries, institutional investors may want to consider leaning into real estate (particularly certain segments) and implementing strategic changes. For an example from history, as markets recovered from the global financial crisis, the NFI-ODCE index[6] delivered a 12.9% compound annual net return for the five years ending in 2014.

However, investing in noncore assets is still more difficult to implement than investing in core assets because the funds are primarily closed end partnerships. It is hard to predict when funds will come to market and how long they will stay open for investment. Although they typically have ten-year terms, it is difficult to predict their actual lives. Some terminate and return capital to investors sooner, and some extend and return later than initially forecast.

Since real estate is a local business, many noncore funds focus on limited geography and property types, raising concerns relating to portfolio diversification, sector exposure and risk. At any given time, there are numerous closed-end funds in the market. For example, on September 30, 2024, Preqin, an investments data company, showed active fundraising by 1,647 U.S., closed-end real estate funds. However, many of

these funds are too small or their managers are too inexperienced for many large institutional investors to consider.

Finally, since closed-end funds request capital from investors over three or four years and return it over a period ranging from as little as one year to as long as 15 years, cash flows are difficult to predict. This uncertainty in timing and liquidity requires ongoing monitoring and management of vintage diversification, liquidity and other risks.

Conclusion

Real estate tends to be cyclical. Successful real estate investors have been:

- Sensitive to and tactical to the cycles
- Thinking long term.

There has been recent discontent with the valuations, performance and illiquidity of the NFI-ODCE fund constituents; however, the index remains useful as a tool to evaluate real estate investments, and many investors still utilize core, open-end funds within their real estate portfolios.

Although institutional investment in real estate has been challenging in recent years, fundamentals remain healthy. With above-average core and noncore risk-adjusted returns potentially on the horizon, history suggests that now might be a good time for investors to reassess and rationalize their real estate portfolios.

Endnotes

1. Liquid investments are frequently and often publicly traded securities such as stocks and bonds. Historically, investors have earned a premium by investing in private investments; however, these investments might be illiquid for extended periods of time. Investors must balance their exposure to illiquid investments with their ongoing needs for liquidity.
2. As of September 30, 2024, these 25 funds had 3,337 investments totaling $282 billion in gross asset value and $207 billion in net asset value. That equates to a relatively conservative leverage ratio of 27.2%. NFI-ODCE allows no more than 35% Tier 1 leverage as defined in the NCREIF PREA Reporting Standards, which uses the fund's outstanding principal balance of debt relative to the fund's gross assets.
3. In addition to investing in at least three of the main property types, funds are required to have no more than 60% of their gross market value of real estate in one property type and have a minimum of 5% in each of the three types they are invested in. In addition, no more than 65% of real gross asset value may be in one geographic region.
4. Funds are generally not required to meet all quarterly redemption requests as they are not required to sell assets to meet liquidity requests. Gating is a mechanism that funds use to limit redemptions by investors. When a fund puts up a gate, investors may only receive a portion of their requested cashout.
5. The NFI-ODCE net return started becoming less negative in the first quarter of 2024, eventually turning to a positive net return in the third quarter of 2024, a trend that most fund managers see as continuing/strengthening in 2025.
6. One might expect noncore funds to perform even better.