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RPM—47 | Real Estate Liquidity Insights with Jeff Giller and Margaret McKnight

Anna Marcus (AM): Hello and welcome to RPM, the podcast where we explore the world of private markets. I'm your host, Anna Marcus, and today we're diving into our Real Estate Liquidity Insights report, where we analyze fund level cash flows and trends shaping liquidity in the real estate market. Joining me today to discuss these themes and more, are Jeff Geller, partner and head of Stepstone Real Estate, and Margaret McKnight, partner and head of portfolio solutions for Stepstone Real Estate. Both Jeff and Margaret are based in San Francisco. Jeff, Margaret, thank you for joining us, and welcome back to RPM.

Jeff Giller (JG): Thanks, Anna. I'm really looking forward to this podcast. Well, there are some big burning questions around liquidity as the real estate cycle progresses. It's all going very slowly, which is normal, and that of course raises the "Are we at the market bottom, yet?" question. In our recent house views, we showed why we think the trading prices and volumes have bottomed out for this cycle. We're likely entering a new cycle, but not taking into consideration how things may change with the implementation of some of the new administration's policies. We thought a liquidity analysis would provide insights on where we are in the cycle and help to answer the question that we get asked by GPS a lot: "Why aren't investors committing capital, despite all you've said in the house views?", that implies that they should be doing that now. Plus, the question on the minds of a lot of LPs: "When am I going to start getting distributions again?" To answer these questions, we delve deeply into our proprietary data base and general market data and put together a paper. We're going to share some of our insights and findings with you right now. So, Margaret, why aren't investors deploying capital into real estate? Prices have come down since their 2019 and 2021 peaks, and the market seems like it's at a bottom. Are investors at risk of acting counter-cyclically again, and missing the best opportunities like they did following the GFC?

Margaret McKnight (MM): Yes they are. Hello and I am glad to be here. One of our main missions is to better inform investors so that they can make good decisions and not miss really interesting market opportunities, so we're going to talk about some aspects of that today. There are the lack of capital deployment has both technical factors and behavioral factors behind it. On the technical side, it's important to understand that investors are very formulaic in how they allocate capital to asset classes, and it's oriented in a top-down way for good reasons. There are really three ways this matters now.

1. We all know about the denominator effect. Real estate is one of the last markets to price correct. And so, everything else goes down, first shrinking the denominator and then stopping new investment. Because the math said investors are overallocated to real estate. That effect began reversing early last year, and most investors are now under allocated to real estate given how robust stock market returns have been recently. However, even the largest investors tend to plan their allocations annually, so in many cases this under allocation is only just flowing through their new deployment plans. So, it should have a lift to new commitments in 25.

And there's other things at play.

2. So, the second factor, and the big limiter, is what we cover in this paper is liquidity. Investors are not getting their money back, so they don't have it to recommit. Capital tends to get recycled in the closed ended fund world. Our data shows that distributions are running 64 below long-term averages. And this is because managers are not selling properties. Asset sales from funds are running 57% below long-term averages, and that far exceeds the broader market drop in trading volumes, probably led by the transitional nature of these assets. On the other hand, capital calls are back to normal one, because managers need capital to feed the assets they're holding, including responding to higher interest rates. And two, because they're finding new investment opportunities. So, investors who, by the way, have a lot of capital committed that hasn't been called that mountain of dry powder, in many cases, feel they already have chips on the table. And now, they may be needing to fund a mature real estate portfolio that pre-correction was self-funding unlikely generating cash. This is also happening in PE, so investors are feeling the squeeze on liquidity, and some have had to do liquidity budgeting, which affects all privates, not just real estate.
3. Then there are other issues in the background. A recent Hodes-Weill report shows that investors are generally maintaining their percentage allocations to real estate, with a bias in the future to a slight reduction in favor of infrastructure, and we're definitely seeing this interest on the ground. On the plus side, this young asset class is growing very interesting. And on the caution side, some of it is truly PE level risk being put in a real asset bucket. So, it's important for investors as always, to know your purpose, your risk tolerance, and to be discerning.

So those are the technical factors. On the behavioral side again remember the key decisions affecting net allocations to real estate are made at the top by CIOs and boards who are not in the day to day of the real estate markets. The big question for them is exactly what you said, Jeff: "Is it the right time?" The answer is increasingly and resoundingly "yes" for non-core for a whole bunch of reasons that we cover in the house views. Confounding all of this, is marks. The carrying values, which have not caught up to the trading values, won high marks are a big factor in the low trading volume which we'll get to, and they are definitely gumming up the works there. Two, they cause confusion. Key decision makers at the top look at their total portfolio level reports, and they see relatively small declines in value for real estate that don't match the carnage that they're seeing in the headlines and walking by on the street. So, they're really doubting whether the market has hit bottom. Granted, most of the headlines are about office, and that shouldn't be a very big percentage of most portfolios. But still, there's a lot of noise. Marks are going to emerge as a bigger problem over time. And it's why, when I'm asked for my most contrarian idea, sometimes I say that pretty soon it just may be putting money into real estate at all. Now, why non-core real estate? Closed ended fund valuations are down 10% since the correction started, and those funds are 55% leveraged with gross unlevered trading prices down over 20%. Valuations on the assets that the fund still holds should be down on the order of 50%, and the unsold assets make up the vast majority of the recent vintage air holdings, mainly 2019 to 21, on which we've seen barely any markdowns. At some point these losses are real, because we're in a higher interest rate regime and the non-core markets have to catch up. And as they do that and come down over the next year or 2 or 3, real estate returns are going to look really bad to the CIOs, and they're not going to want to deploy. That's the behavioral problem. So, even though it's likely the best time in the 15-year cycle to commit to non-core real estate, they may pull back. So, we have to educate decision makers to get them through this and make sure that they aren't rear view mirror investing and missing all the gems amid the turmoil.

JG: Let's talk about the lack of sales and distributions. We had interest rates jump and trading values declined. Marks are still higher than trading prices, so GPs don't want to sell because it forces them to recognize losses.

Many are doing their best to hold through the cycle and to sell in better times, hoping for lower interest rates, or to grow out of it on the income side as the economy recovers, or at least to sell when there is there's more liquidity in the market and competition pushes up pricing. Funds, especially newer ones with lower initial borrowing rates that used higher levels of leverage to drive their returns are likely to have big funding gap problems. Although average leverage levels are 55%, they may be higher for certain assets and for newer funds. So many are over leveraged, and the cost of care is a problem. Also, their rehab or development programs may have experienced cost overruns and delays from inflation and supply chain problems. And now leasing is also slowing. And for IRR based funds, time is the enemy. Margaret, can we put some numbers on this?

MM: Okay. So, first, we suspect that most of the actual selling being done by the non-core funds is forced selling, largely because these sales are happening at an average loss ratio of 30%. Now, much of that number is the issue with the marks. If the assets were already marked to the current trading prices, the sales wouldn't generate losses, but of course then they'd have to post losses across the board to fix the marks, not just on the sold assets. With valuations so opaque, plus the feeling that it's okay to be off because no one's getting paid based on these marks in the closed ended fund world, and a direct correlation to fundraising, you see why there's resistance here. We've talked about this before. It's a true prisoner's dilemma. If it's a bad vintage year for everyone, it's a lot easier to raise money than if your fund did relatively poorly. So, you risk getting shunned by investors. Even if that happened just because you marked properly, and the others didn't. Note also, it's not an easy needle to thread, but for a particular GP amid low overall liquidity, if your funds have returned a lot of capital to your investors, it's much easier to get the next LP commitment than if you haven't. DPO, distributed paid out, really matters. All of this means that the average holding period for assets in closed ended funds has gone from about three and a 3 and a quarter to four years. Not surprisingly, holding period lengths are cyclic. They peaked in oh six and oh seven vintages, which ultimately delivered the lowest returns of the last cycle. Assets purchased from 20 to 22 are well behind pace on sales, already. More importantly, historical loss ratios start going up after about a four-year holding period. They reach an average of over 10% by year six, and they just keep climbing. Holding on to problems doesn't make them better. Also remember, if you're trying to wait out a problem, you actually need a huge back-end lift to raise a poor IRR, given how IRR math works, and this rarely happens. So, on average, the multiples for vintage years that were not troubled flatten out as holding periods extend with no improvement in the multiple after a four-year hold. So, this means IRRs are going down as assets are held longer. The GFC vintages are interesting because one factor did move in owner's favor. Interest rates did drop, so extend and pretend legit worked. Sadly, we don't think that's going to happen this time. Even with that going for them, the GFC vintages underperform substantially, and this did not improve with longer holding periods. The 4 to 6 year holds dropped down to break even multiples, which was well below the shorter holds. So that would have been for assets sold before the GFC. And then, again, the multiples stayed roughly flat on the longer holds, so IRR precipitously declined Again on average, there's a strong case for just ripping the band aid off and selling the problem assets. Not to say that's true for every asset or every GP, but generally the odds are not in favor of a big back-end lift on returns. So, this circles back to fundraising and the prisoner's dilemma problem. Fundraising is down about 30%. It will likely start to recover amid, you know, with the denominator effect flowing through, but amid bad news on marks from the pre correction vintages and liquidity challenges. So, slowly. Our data says it's now taking twice as long to raise a fund as it did in 2017. So now it's at nearly two years. Average fund size is up 130%, and if you have a smaller fund, it takes even longer to raise.

JG: Right, so, if a GP can survive to raise their next fund, they have good odds of delivering stronger returns from the better vantage to come and keeping their franchises going.

The hard part for investors and a place we spend a lot of our time, is trying to discern the strategies and the specific GPS that will be the winners over time. This is a lot easier to do for funds with longer track records, of course, the 2019 and 2022 vintages are eventually going to show who got it right in this last down cycle, and who avoided the real problems when the tide went out. Even more importantly, during these challenging times is to not get spooked by the inevitable down years in a cyclical business. The present situation offers a rich opportunity set for investors, and one we don't recommend missing.

AM: Jeff, Margaret, great to have you both on RPM.

JG: Thanks, Anna, thanks, Margaret, I really enjoyed our discussion.

MM: Thanks everyone for listening.

AM: For more information on this topic, head to StepstoneGroup.com, where you can download our full Liquidity Insights White Paper and view the rest of our Thought Leadership library. Also, feel free to check out our recent article, “No one else to blame: without distributions, funds can't raise capital” in the winter 2025 PREA Quarterly. You can find the article on their website, prea.org or reach out to us for the link. Listen to RPM wherever you listen to your podcasts.