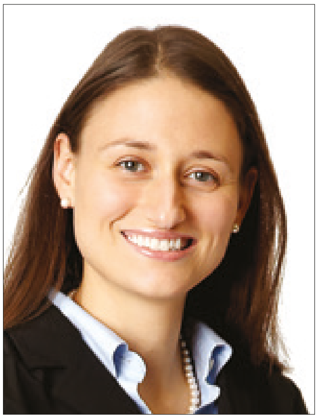
KEYNOTE INTERVIEW

Providing liquidity in good times and bad



Ares' Michelle Creed and Jamie Sunday see real estate secondaries opportunities abound

Michelle Creed and Jamie Sunday are both partners and co-heads of real estate secondaries within Ares Secondaries Group at Ares Management, and formerly partners at Landmark Partners before its acquisition by Ares Management almost two years ago. With more than two decades of experience, their track record is almost as long as Ares' – Landmark Partners was the first entrant to the real estate secondaries market, in 1996.

Creed and Sunday consider how the space has changed and where it is headed next, with another record year in prospect as activity recovers following the steep interest rate rises of 2022.

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Q How does the secondaries space compare with when you started in the market?

Michelle Creed: The very definition of secondaries has changed and continues to change. It is becoming broader.

We define ourselves as being liquidity providers to any holder of institutional real estate typically held in an existing fund, partnership or joint venture. Most often we are working with existing investors looking to sell, as well as GPs considering fund or portfolio recapitalizations.

In this role of liquidity provider, we are able to differentiate ourselves in a few key respects. The first of these is simply size, which gives us a considerable advantage; at 24 people, we believe we have the largest team dedicated exclusively to real estate secondaries.

We remain flexible in terms of looking at small opportunities, but I think it is crucial that we are scaled and equipped to provide holistic solutions to very large investors and funds. This requires size. There is a lot of complexity in the transactions we become involved with, and having multibillion-dollar capital behind you is important.

Secondly, I would say experience. Having completed the first ever real estate secondaries transaction in 1996, we have by far the longest tenure and track record in the real estate secondaries market.

In addition, we have purposely built a team with individuals who have experience in the direct real estate market, having worked at real estate private equity firms, developers, etc.

This gives us a particular understanding of the needs of the market we are operating in. Finally, I would say a key differentiator is creativity, which is very important in such a volatile market.

Q How has that volatility affected transaction levels?

Jamie Sunday: Last year was a record year for real estate secondaries transaction volume at $12.4 billion, a significant increase on the $10.6 billion of transactions that occurred in 2021 – itself a record.

This record volume occurred in a year that was very much of two halves. Once interest rates started to rise, transactions began to decline. This happened gradually in Q3 and then more rapidly in Q4, as a lot of buyers and sellers hit the pause button.

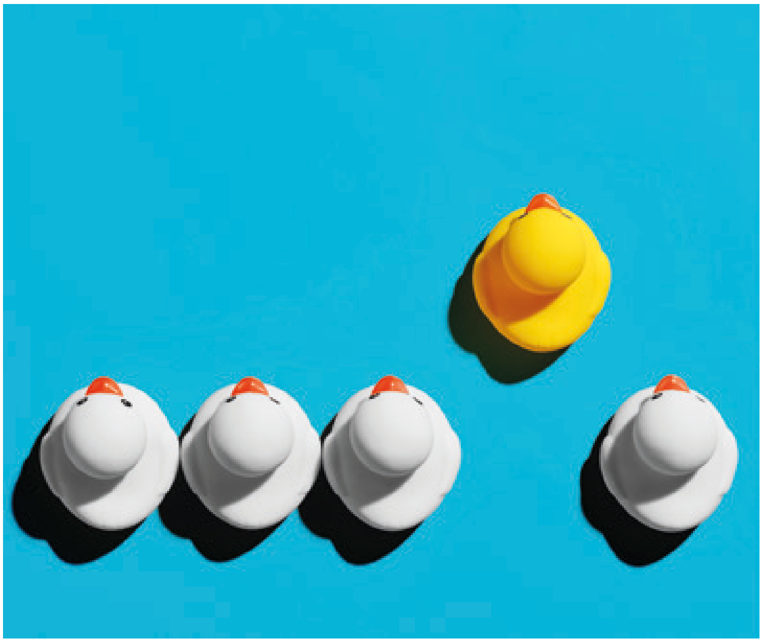
As valuations came under pressure, many investors were presented with pricing options that optically became more challenging to execute on. For example, a public pension fund may be prepared to sell at a discount of 20-30 percent, but may be unlikely to do so at a discount of 50 percent.

Q Why were there so many GP-led transactions in 2022?

JS: The number of GP-led transactions in real estate has grown significantly the past few years but is still in the early innings. In 2022, GP-led transactions reached a record $9.5 billion, 77 percent of total volume and a 35 percent increase over the $7 billion achieved in 2021. Given overall capital markets volatility and increasing financing rates, GPs looked to the secondaries market to provide some liquidity to legacy fund vehicles and LPs.

The private equity sector has become very accustomed to utilizing the secondaries market and continuation vehicles as a way to monetize investments. In real estate, this is a relatively new phenomenon that is gaining good momentum. In 2022, several large-scale portfolios were sold to continuation vehicles via GP-led recapitalization transactions.

There is more than $130 billion of NAV held in closed-end fund vehicles that are already nine to 10 years old. This is driving more and more fund sponsors to be proactive and to tap the secondaries market for recapitalization solutions to provide for more time and capital to continue business plans and to generate some liquidity for LPs.



MC: We are seeing investors who weren't trading, or were scared off, starting to return to the market now that the necessary write-downs have begun. There are some very large portfolios that want to deploy capital at present, and we are seeing a pick-up in transactions.

I would very much anticipate that transactions in the first half of 2023 will be up considerably on the second half of 2022. This is because LPs are starting to participate again, whereas in 2022, 77 percent of transactions were actually GP-led.

Q Where are the opportunities now in the market?

JS: Industrial and logistics continues to be a key theme, along with student housing – especially in the UK and Europe.

US residential rental is also compelling. With mortgage rates above 7 percent, 400 basis points above a year ago, this makes the affordability for house purchases painful, driving individuals into the rental market.

On the negative side, there is no question that the office sector is struggling. I don't think it is yet clear how significant the impact of widespread working from home will be, but it is definitely something buyers are evaluating.

There will be a lot of pain as loans come due, and there are increasing incidences of managers needing to give the keys back to the lenders – but the lenders being reluctant to take the keys!

MC: I think it is hard to have a clear picture on working from home, particularly because there are very few office transactions in secondaries. We are still all trying to figure it out, although new build high-quality properties in central locations are very much in favor.

The other difficult sector at the moment is retail. The important point to make there, however, is that retail is really a series of different subsectors. We would want to avoid shopping malls, but then again, they very rarely appear in institutional portfolios.

We are still comfortable with any retailing outlets that are regarded as 'necessary,' such as grocery. Overall, though, I have to say there are not a lot of compelling opportunities in high street retail at the moment, and very little generally from the retail sector in the secondaries pipeline.

> *"There are some very large portfolios that want to deploy capital at present, and we are seeing a pick-up in transactions"*
>
> **MICHELLE CREED**

Q Where is the secondaries market headed?

JS: I strongly believe there is still significant growth to come. Just do the math: the total amount of net asset value held across closed-end real estate funds is approximately $900 billion, which could be further increased by the $400 billion-$500 billion of uncalled capital that will get invested at some point.

In the private equity secondaries market, annual turnover rates range from 2-3 percent. In the real estate secondaries market, it has been closer to 1 percent. Much of this gap is due to the lag in growth and evolution of the real estate secondaries market when compared with the private equity secondaries market.

Assuming a turnover rate of 2 percent of the $900 billion will create an $18 billion-$20 billion market. In addition, the $900 billion of real estate fund NAV doesn't include real estate portfolios held in non-fund structures such as joint ventures, co-invest vehicles, private REITs, etc. The amount of net asset value held in these vehicles is hard to quantify but is substantial and will contribute to the growth of real estate secondaries transaction volumes.

It is also interesting to note that there are high-quality real estate portfolios (eg, industrial, life sciences, etc) held in closed-end funds that fund sponsors increasingly do not want to get rid of. In those cases, potentially the only way that an investor can get access to these portfolios is through GP-led recapitalization to a continuation vehicle.

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>
> **JAMIE SUNDAY**

Q And what of the collapse of SVB and a possible secondary banking crisis. How will this affect the secondaries market?

MC: It is still very early days and we are certainly having to cope with added volatility and uncertainty. However, ultimately there will be big issues for legacy portfolios with debt maturities. We have started to see some bank lending dry up and this is leading to very motivated sellers.

JS: Having a number of motivated sellers is a good situation for us. A lot of these loans will require partial paydowns in order for the borrower to get an extension. For funds that do not have any remaining uncalled capital, we can provide preferred equity and other financing solutions. ■