



For Real This Time – Transactions in the Real Estate Secondary Market Set to Grow

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It's like clockwork. Every few years, a news story comes along announcing the incipient burgeoning of the real estate secondary market. And while the real estate secondary market has increased in size, it has yet to fulfill the promise of really taking off – this time, though, things might be different.

A comparison of the real estate secondary market with the private equity secondary market (which has grown from US\$2 billion of annual transaction volume in 2001 to US\$13 billion in 2007) suggests real estate may be positioned to follow in the exponential footsteps of the private equity secondary market. By contrast, Landmark Partners, which specialises in buying secondary interests in real estate and private equity funds, estimates that a total of US\$5 billion of real estate secondaries have traded over the life of the industry. That is set to grow in the next couple years. Landmark predicts transactions in the real estate secondary market during the next 12 months could exceed US\$1 billion.

According to Craig Marmer, a partner with Probitas Partners, which acts as an intermediary on secondary transactions, the private equity secondary business has really evolved over the years to be a multi-billion dollar industry. "We're seeing the same kind of thing in real estate," adds Marmer.

From the general partner's perspective, secondary real estate transactions have been few and far between. According to one opportunistic real estate fund manager, who spoke on the condition of anonymity, there's generally very little transferring of fund interests. There's been "a smattering of sales" – no more than "two or three total over the last six months," the fund manager says.

Laura Huntington, managing member at Institutional Property Consultants (IPC), acknowledges that real estate secondary transaction volume has not reached the level of private equity secondary volume. "While private equity has embraced the secondaries market, you are starting to see more interest on the real estate side," Huntington says. She points to the fundraising success enjoyed by fund managers targeting the real estate secondary market, such as Liquid Realty Partners or Landmark Partners. "Clearly, there is an admission by plan sponsors that the market is growing," notes Huntington.

Scott Landress, managing principal and CEO of Liquid Realty, says the real estate secondary market has grown during the past decade: "In 1998, real estate private equity investors had no real options to obtain early liquidity for their portfolio interests." He notes that the entry of firms dedicated to buying secondary interests has increased the options available to investors, resulting in a "slow but steady increase in recent years in real estate secondary transaction volume."

In combination with a cyclical change in the commercial real estate market, these factors point to a coming expansion of the real estate secondary market. Although institutional investors are reluctant to disclose their secondary interest transfer activity, industry insiders say several large portfolios have come on the market or are in an information-gathering phase.

"We're seeing a substantial increase in inbound inquiries," says Jamie Sunday, principal with Landmark. "Most of these inquiries are from investors who have not previously utilised the real estate secondary market."

The Sell-side

Despite a perception by some in the real estate industry that sales are driven by investors' disappointment with a fund manager, the primary motivation for secondary sales seems to be portfolio management.

"In our experience, limited partners have a wide variety of reasons for selling their real estate fund interests, and those reasons may also vary throughout the market cycle," says Landress. "That said, most secondary sales can be generally characterised as portfolio optimisations."

"Surprisingly, it is rarely a motivation to sell that the holder doesn't like the manager," notes Gary Stevens, head real estate partner with Landmark. Instead, Stevens says the main reasons for selling are an over-allocation to real estate, an over-exposure to a particular vintage year and a desire to shift strategies,



especially to international and mezzanine funds. In addition, the increase in the number of manager relationships over the past few years has become overwhelming for investors, and many institutions are looking to pare back their relationships.

Sellers also can be event-driven, such as in the case of a defined benefit plan that's being scaled down or a merger of financial institutions that causes an overlap of investment fund portfolios. Post-credit crunch, a seller's need for ready cash also may prompt sales. According to one opportunity fund manager, "The people who tend to sell are financial institutions who need to raise liquidity."

Other possible sellers are discretionary portfolio managers. Reflecting the prospect for higher margins and increased control over investment decisions, several real estate consulting firms have been moving into the discretionary portfolio management arena in recent years, states Huntington, who expects these firms to become more active in their management of those fund portfolios.

"Many of these relationships are premised upon the concept of active portfolio management. As such, you would expect them to view the secondary market as a tool in the portfolio management process, particularly on the sell-side, for both tactical and strategic reasons," she says. "If you're actively managing a pool of funds as a discretionary manager, you need to look across your funds and constantly evaluate performance relative to original underwriting and expectations going forward given current market conditions." She notes that as part of their portfolio management, discretionary managers would look to diversification and performance.

"Unfortunately, the secondary market isn't utilised as much as it could be," acknowledges Huntington. "Real estate has been slow to move in that direction."

One reason sellers have been slow to take a more active role in the management of their portfolios may be that there continues to be a stigma attached. Some institutional investors and fund managers are even reluctant to talk about transferring fund interests.

"It's a small community, and you want to be viewed as a good long-term partner," explains Marmer.

"The general partners on the real estate side are just now beginning to be exposed to the sell-side and need to get comfortable with it," says Alan Bear, a principal with Probitas. "As part of any secondary sales process, the general partners need to be involved very early to make it work." Limited partners cannot transfer an interest to another party without the general partner's approval.

"Some general partners are more receptive to the concept of a transfer than are other general partners," notes Huntington.

Private equity general partners, however, have gotten considerably more comfortable with secondary investment. "Even as little as five years ago, on the private equity side, you'd call up the general partner and they'd say, 'What did I do wrong?' That's, for the most part, gone away," says Marmer.

The Buy-side

While there are many possible sellers of real estate secondary interests, the buy-side is largely concentrated in the hands of three groups: Liquid Realty, Landmark and Credit Suisse. In addition, a few fund of funds operators have made the occasional secondary investment. However, buyers of secondary interests are really limited to firms "that have the staffing and the resources to thoroughly underwrite and price the underlying assets comprising the fund," Huntington says.

Bear agrees the buy-side has been limited to a few firms but says acquiring funds on the secondary market is a way to "buy into a diversified portfolio quickly." For example, "a new fund investor, or an investor wanting to quickly scale up their portfolio, could take down a sizeable portfolio to achieve their goal," notes Bear.

One barrier to growth in the secondary market is the difficulty involved in pricing secondary interests. It can be hard for a limited partner to be involved on the buy-side and to evaluate a fair price. "We spend a lot of resources and money underwriting that offer," says Landmark's Stevens.



"The hard part is pricing," Stevens adds. It's possible to value properties, but enormously complicated to figure out a fund's cash flows, he adds. In some instances, there might be an operating partner, and it becomes necessary to understand how the fund works, how it charges fees and carried interest. Pricing an interest involves essentially coming up with a present value of a future cash flow stream and then comparing it to net asset value – which is the seller's measure of value.

Buyers might be willing to pay more for an interest with more information about the fund. "More information reduces my risk," Stevens says.

Changing Conditions

Impetus for the increased interest in the real estate secondary market has come from the changing economic environment. While commercial real estate fundamentals remain strong, valuations have begun to soften. At the same time, the slowing US economy and weakening performance by equities have reawakened the spectre of the denominator effect.

"The real estate market had been on an unprecedented bull run...and, in general, limited partners were focused on increasing their positions rather than liquidating them," notes Jeffrey Giller, managing principal and CIO at Liquid Realty. "Since market dislocation typically changes investors' circumstances and outlooks, we expect an increasing number of real estate limited partners to begin to explore their liquidity options in the coming years."

According to Landmark's Stevens, it's not so much that real estate valuations are falling but that real estate has performed so well for so long. "In that environment, it's really difficult to make the decision to sell," Stevens notes. He adds that real estate valuations hit a cyclical peak in 2007, which has made it easier to convince boards that the time is right to sell real estate.

The real estate secondary market is evolving just as the secondary market for private equity fund interests has evolved during the past ten years. On the private equity side, the size and number of secondary market transactions are largely a function of the size of the underlying primary fund market. The increase in real estate secondary transaction volume is simply following the high growth that the real estate primary fund market has experienced during the past few years.

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