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LP Perspectives

A Judicious Use of Risk: LP Allocations Set to Increase

Despite being well into the later stages of the current commercial real estate cycle, institutional investors around the globe look likely to continue allocating capital to real estate over the next couple of years, with about half of them expected to increase their investment in the asset class.

"Real estate looks pretty attractive on a relative basis, when you compare it to other asset classes," said Greg MacKinnon, director of research at the Pension Real Estate Association (PREA). "That, in large part, is driving this increase in real estate [appetite]."

According to the results of PREA's 2018 Investment Intentions Survey, conducted in conjunction with the European Association for Investors in Non-listed Real Estate Vehicles (INREV) and the Asian Association for Investors in Non-listed Real Estate Vehicles (ANREV), average allocation, weighted by assets under management (AUM), to real estate globally is 8% – below the average AUM-weighted allocation target of 8.7%.

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> **Greg MacKinnon, PREA**

"Over the next couple of years, I cannot see the appetite for real estate disappearing, at least not in any significant way," said MacKinnon.

Indeed, investors from all three regions – the Americas, Europe, and Asia – remain below target with respect to real estate, and approximately half of those investors reported that they expect their allocations to real estate to increase over the next two years. For U.S. investors, the average allocation is just 7.3%.

Seeking Value

With institutional players planning to continue plugging capital into real estate, at least in the near term, and uncertainty growing about when the real estate market might experience a turning point, the question for investors becomes how to put that capital to work in a prudent manner.

For those looking to invest in U.S. real estate, that means focusing on value-add strategies.

According to the PREA survey, the majority of investors believe value-add to be the most attractive style for U.S. real estate investment, and more than half of investors rated value-add as the best performing investment style in the US in each of the last five years.

IN THIS ISSUE, INTERVIEWS WITH:

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"The way I interpret that," said MacKinnon, "is investors are looking at [the U.S. real estate market] and they're saying, 'Returns are relatively low historically. How are we going to eke out some extra returns here?' They are willing to go one little step up the risk spectrum but they're not going to go too far, so value-add fits that bill sort of right in-between."

As value-add was viewed as the most attractive style, perhaps it is not surprising that the majority of investors globally – some 61% – intend to make value-add investments in the U.S. this year. Among North American-based investors, value-add is by far the most popular strategy, with 69% of such institutions intending to make such investments.

"If interest rates go up and continue to go up, that's likely going to be a reflection of the fact that the economy continues to do well," said MacKinnon. "If the economy continues to grow, then it's those value-add projects that [will be] able to take advantage of that by increasing their occupancy or increasing their rent growth."

Driven by Income

Another factor contributing to the popularity of value-add is the fact that total returns on U.S. real estate increasingly are being fueled by returns from income, rather than returns from capital appreciation.

According to the NCREIF Property Index (NPI), the income component of total returns has held fairly steady over the past three years, while the appreciation component has declined from roughly 8% in 2015 to just 2.5% by the second quarter of 2018.

Returns from capital appreciation, however, will compress further as the cycle matures. PREA's Consensus Forecast for NPI predicts returns from appreciation to be just 0.3% by the end of 2019 and sliding into negative territory, -0.5%, by 2020. That means investors and managers will no longer be able to rely on capital appreciation to boost their investment returns, and will need to create their own value in order to bolster income returns,

Japan

Far East Returns West — But It Won't Be a Quick Shift

According to PREA's 2018 Investor Intentions Survey, one-quarter of the planned capital deployment for real estate in 2018 comes from North America, whereas the Americas is the destination for 35% of planned investment this year. This implies that the Americas, particularly the U.S., should expect to see an overall inflow of overseas capital during the year.

Among overseas investors, Asian institutions continue to show heightened appetite for U.S. real estate. Singapore, South Korea, and China have driven a good portion of overseas investment over the past several years, but with China recently pulling back on overseas investment in real estate and even looking to divest some holdings, the question becomes who will step up. The answer may be Japan.

The Japanese Mindset

"The Japanese institutional investor universe is very sizeable, and it's pretty diverse in terms of the types of groups that are thinking about making investments," said Walter Stackler, managing partner at Shelter Rock Capital Advisors, which recently formed a strategic alliance with Japanese capital advisory firm Matrix.

"Many of those investors have been faced with low growth in their home country and, as a result, have been looking abroad to find ways to put more capital to work," he said.

Following their experience with U.S. real estate in the 1980s, most Japanese investors pulled back from making allocations to the U.S. entirely. Now they are thinking about how to start a new program from scratch.

Many Japanese investors prefer to be direct investors in the U.S., as they also invest in real estate directly in their home market. "There are investors that are comfortable with funds – and there's quite a few of them – but there's definitely a number that are only comfortable directly or with a joint venture partner," said Stackler.

With significant capital flowing to the major U.S. markets, Japanese investors realize they may be able to find more attractive transactions in secondary markets. "Many are focused on the key U.S. gateway markets," said Stackler. "However, there is a subset of investors that are thinking about other places to allocate capital in the US."

According to Stackler, the key item for Japanese investors is how to find opportunities that are not competitively shopped and where they can invest at a compelling basis. "They are increasingly making sure that they are allocating to investments where there's going to be real opportunity for net operating income [NOI] growth," he said. "NOI growth hopefully will mitigate any cap rate expansions that may be occurring."

That said, don't expect a wave of Japanese capital to wash ashore all at once. "The potential is tremendous, but I think they're going to be cautious and move carefully," said Stackler. "We're talking about a 10-year trend, not a 24-month shift."

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Greg MacKinnon, PREA

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which are expected to hover between 4.7% and 4.8% for the foreseeable future, according to PREA.

That said, managers are likely to have a shorter window in which to create value.

“At the same time as investors are looking at value-add investments, they’re shortening their time horizon on the value-creation process in a lot of cases,” noted MacKinnon. “They are not as interested in getting into projects where the time horizon to create value is three or four years.”

Indeed, investors are looking to slash the typical two- to three-year investment period in half to just 12 to 18 months in order to mitigate leasing risk and uncertainty during these late stages of the real estate cycle.

“There’s no exact rule, but certainly the time horizon on value creation has come in quite a bit because of this fear that we may be nearing the end of the cycle,” said MacKinnon. “A lot of the projects investors are most interested in, or at least trying to find, are those projects where the value creation is going to occur in 12 or maybe 18 months.”

Moving Beyond Primary Markets

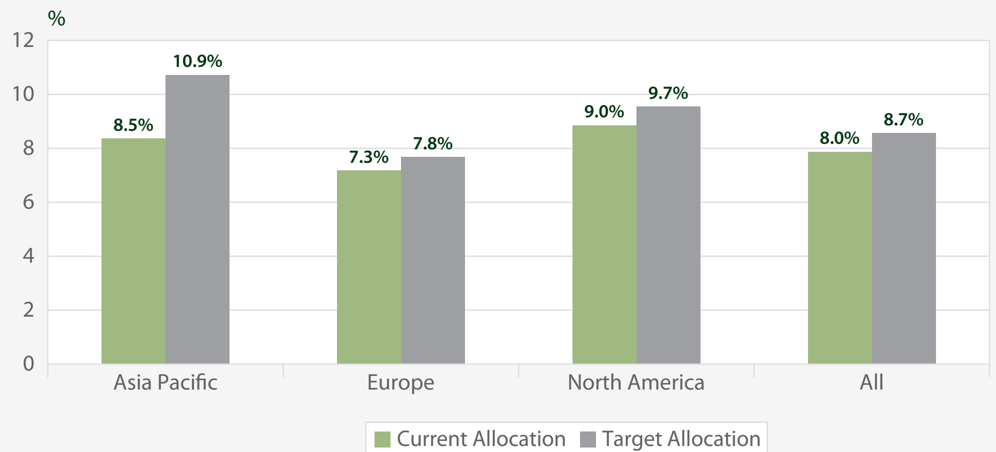
In terms of where investors are seeking such value-add investments, they are rarely found in the big gateway markets anymore. Instead, investors are looking to secondary coastal cities and regional powerhouses in the middle of the country.

Although overseas investors continue to remain concentrated on the major primary markets for their US investments, the PREA survey found US-based investors targeting markets on a more widespread basis this year. Indeed, ‘Other East Coast’ and ‘Other US regions’ are more popular with US-based investors, with 45% of such institutions intending to invest in those regions over the course of the year.

“It’s nice to see investors looking more seriously beyond New York, San Francisco, Chicago, Los Angeles, Boston, and Washington, D.C., and at some of the very dynamic economies in some of the secondary markets out there, especially through the middle of the country,” said MacKinnon.

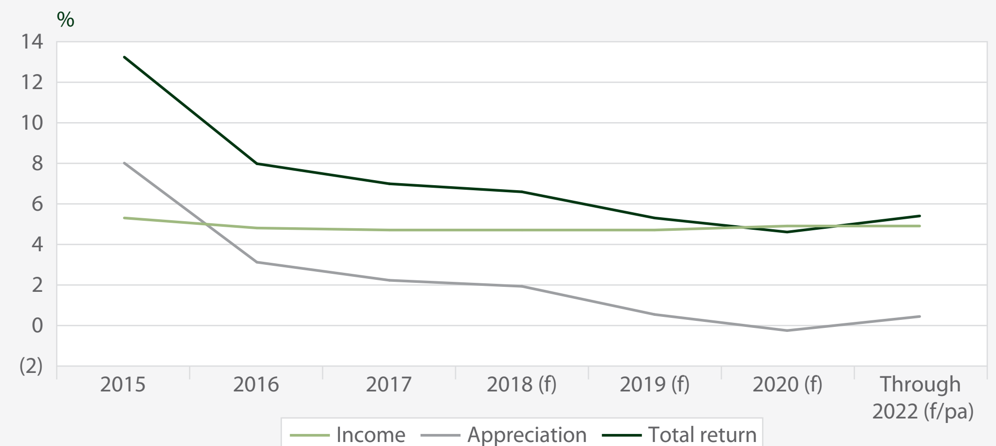
“What sometimes still is called flyover country has some of the best real estate investment opportunities these days,” he said.

Current and Target Investor Real Estate Allocations



Source: PREA Investment Intentions Survey 2018 (January 2018).

Source of Real Estate Returns



Source: NCREIF Property Index (NPI) for 2015–2017 (January 2016–August 2018); PREA Consensus Forecast for 2018–2022 (Q2 2018)

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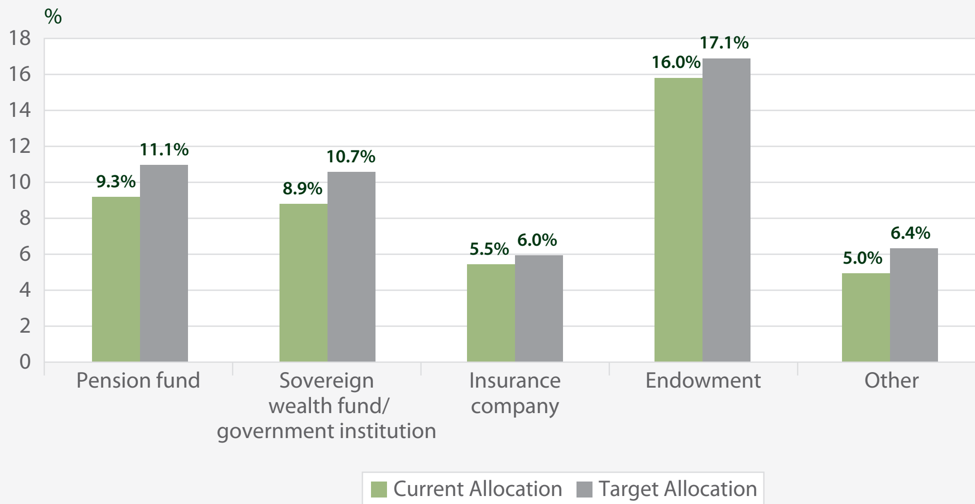
Net Lease Trends

Industrial recovery bolstered by Asian investors

Single tenant industrial net volume rose to $22 billion in the first five months of 2018, just shy of the 2015 post-crisis peak, as Asian investors lead in cross-border deal activity, almost 40 percent more than Canadian, European, and Middle Eastern funds combined.

Average Current and Target Allocation by Investor Type



Source: PREA Investment Intentions Survey 2018 (January 2018).

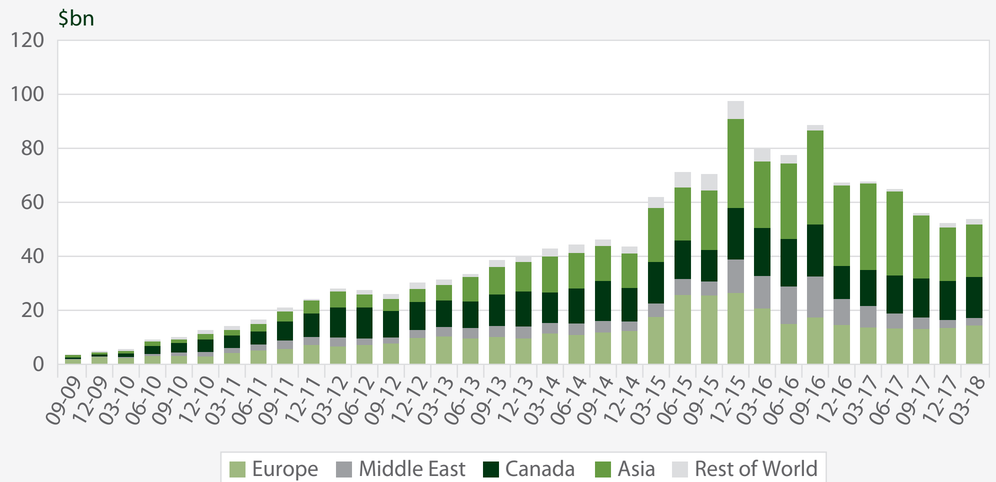
Pensions, SWFs have largest gap between current and target allocations

Endowments may have the largest current and target allocation to the real estate asset class globally, but pension funds and government institutions, such as sovereign wealth funds, have the largest gap between current and target allocations at 180 bps.

Asian investors increasingly important for U.S. CRE deal flow

Cross-border capital made up 11 percent of U.S. direct transactions in the first quarter of 2018, with Asian investors playing an increasingly important part of the foreign investor landscape. Canada and Europe continue to have a sizeable presence, but with fewer petrodollars to be recycled into U.S.-dollar-denominated investments, the Gulf States have generally slipped in the rankings.

Cross-Border Investment in U.S. Commercial Real Estate



Source: Real Capital Analytics (May 2018). Based on independent reports of properties and portfolios $2.5m and greater. Data believed to be accurate but not guaranteed

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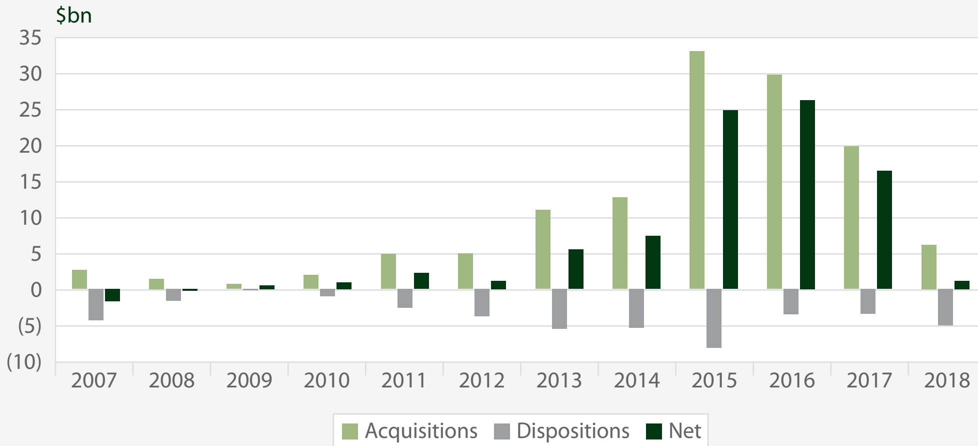
Asian Investment in U.S. Real Estate



Source: Real Capital Analytics (May 2018). Based on independent reports of properties and portfolios $2.5m and greater. Data believed to be accurate but not guaranteed

Asian investors invested more than $16bn in the U.S. in 2017

Net investment in U.S. deals by Asian investors totaled more than $16.5bn in 2017 – almost 40 percent more than the combined net investment of investors from Canada, Europe, and the Middle East. Asian net investment in U.S. property transactions totaled $25.1bn in 2015 and $26.5bn in 2016.

Industrial leads single tenant transaction volume, while office and retail decline

Single tenant industrial deal volume hit $22bn of transactions recorded in the year to the second quarter of 2018 – just $600m shy of the post-crisis peak of $22.6bn achieved in 2015. That compares to declining transaction volume for office and retail, with single tenant office transactions back to 2013 levels.

Net Lease Transaction Volume

Source: Real Capital Analytics (June 2018). Cap rates and PPU displayed as a 12-month average. Volume displayed as 12-month totals. Includes property or portfolio sales $2.5m or greater. CPPI at $2.5m or greater

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