

Bull Market for Real Estate Secondaries

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Introduction

We expect bull market conditions to emerge for real estate secondaries out of the turmoil in the broader markets. Higher interest rates are causing declining values and liquidity issues for both general partners (GPs) and investors (LPs). GPs need capital to fund the gap between their current loan balances and the refinancing proceeds they can obtain in today's significantly higher interest rate environment, and to complete value-added projects on their existing assets. The recent spike in interest rates has caused property values and therefore property sales activity to decline, resulting in declining distributions to LPs that they had counted on to fund their other investment commitments and their institutional obligations. These factors should drive a rich opportunity for secondary investors to provide the capital to solve GPs' and LPs' liquidity issues.

By way of background:

- After the Global Financial Crisis (GFC), the real estate secondaries market developed a more broadly accepted portfolio and liquidity management tool for LPs.
- The GP-led secondaries market commenced with recapitalizations of liquidity constrained real estate vehicles during the GFC, and as the market recovered, it evolved to meet other GP liquidity needs such as for fund continuation vehicles and platform expansions.

The Funding Gap

In the current environment, leveraged owners will need additional liquidity to avoid selling assets amid falling prices in two main ways.

1. When their loans mature, higher interest rates will cause their refinancing proceeds to be markedly smaller than the payoff amounts of their existing loans. The owner must fund the gap, give the asset back to the bank, or sell in the open market. This "cash in" situation is the opposite of the "cash out" refinancings that real estate owners enjoyed as interest and cap rates declined in prior years.
2. Even without imminent debt maturity, floating rate borrowers will need to fund higher interest costs, margin calls related to hedges, or both. Replacing expiring hedges, which is required by many loan documents, has become quite expensive. Lenders' ability to be flexible with these provisions is limited in this environment of falling values, their ability to reinvest their capital into higher returning assets and regulatory pressures.

In both situations, rising project costs, common in this inflationary environment, and leasing challenges, common in a slowing market, tend to increase the need for capital infusions.

Non-core private real estate GPs, including many sponsors of value-added and opportunistic vehicles, are likely to face liquidity challenges in their portfolios. These vehicles normally employ meaningful leverage, and the transitional nature of the buy, fix and sell strategy means that they often use floating rate debt, which is vulnerable to interest rate increases, and thus increases the risk of liquidity challenges.

Three ways to resolve a funding gap:

1. **Fund it out of pocket.** If the existing owners judge the asset to be worth the follow-on investment and have the capital, this is the simple solution. It is reasonable to expect that reserves and a meaningful amount of the dry

powder in partially invested funds will be deployed in this manner. If the vehicle does not have the capital, it can be difficult to raise from existing investors, particularly when they may be facing their own liquidity issues from the denominator effect and delayed distributions from their other private markets investments.

2. **Raise it through a recapitalization.** Conventional debt funding for these types of recapitalizations is relatively scarce, especially for comprehensive solutions for funds and other multi-asset investment vehicles. This leaves GP-led secondaries, which include recapitalizations, as an important source of liquidity. GP-led secondaries solve the GP's problem of either having to come up with the capital to fund the gap, or to walk away from good assets that can deliver returns in the recovery period. These recapitalizations can be structured as common equity and dilute the existing investors, as preferred equity senior to the existing investors in the capital stack, or a myriad of other ways. Funding gaps will affect GPs and their assets across the quality spectrum which should leave secondaries investors with a rich pipeline of opportunities.
3. **Sell the asset.** Sell the asset in the open market or turn it over to the lender, who will sell it. This is necessary if the owner or their LPs are either unable or unwilling to fund the gap.

EXAMPLE: FUNDING GAP AT MATURITY

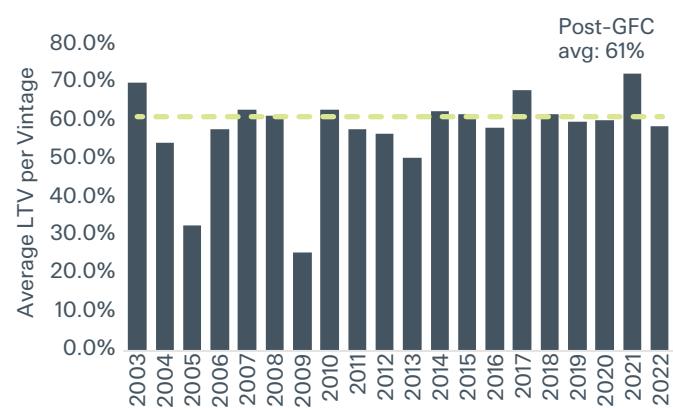
An example of how funding gaps emerge is provided in **Figure 1**. The example illustrates the impact of what has been a doubling of borrowing costs over the past year. It is based on a property valued at \$100 million in January 2022 with a \$75 million loan maturing in March 2023. The starting point of 75% loan-to-value (LTV) sits between the post-GFC average of 62% for global non-core real estate funds (**Figure 2**) and the 80% LTV for 2021 vintage funds.

FIGURE 1: ILLUSTRATIVE EXAMPLE OF THE FUNDING GAP

	Jan-22 Maturing Loan	Mar-23 New Loan	Owner Options
Property Value	\$100M	\$75M	
Equity			
Debt	\$75M	\$34M	\$41M Gap
Cost of Debt	2.8%	6.0%	
DSCR	2.2x	2.2x	
LTV	75%	45%	

Figures reflect hypothetical stabilized multifamily asset with 10-year fixed rate debt. Sources: StepStone Real Estate data, US Federal Reserve Bank, Bloomberg, March 2023.

FIGURE 2: AVERAGE LTV OF GLOBAL NON-CORE REAL ESTATE FUNDS BY VINTAGE



Source: SPI Research, data as of July 2023. Sample size for 2023 vintage too small for comparison.

- Cap rate expansion of 150 basis points (bps) reduces the property's value from \$100 million to \$75 million.
- New loans are based on Debt Service Coverage Ratios (DSCRs). Assuming no diminution in net operating income, maintaining a constant DSCR results in a new loan of \$34 million, which is \$41 million short of covering the maturing \$75 million loan payoff.
- The owner could keep the asset by funding the shortfall or sell the property.

Secondary recapitalization infusions can be used to fund these gaps. A secondary sale could also:

- Take out some or all existing investors who are unable to fund the capital calls required to pay down the loan because they are facing liquidity pressures of their own; and/or
- Fund capital shortfalls occurring for other reasons.

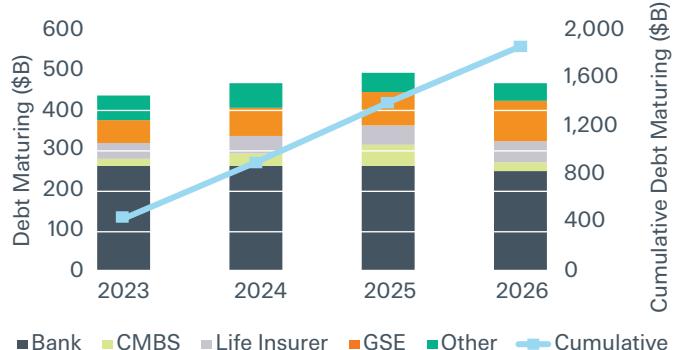
The need for liquidity could be greater if the replacement loan falls short of the level in the example or can't be obtained. The new capital would enter at or near the adjusted basis reflecting the higher interest rate environment.

THE SCOPE OF THE PROBLEM IS LARGE

The scope of the refinancing challenge is large as demonstrated in **Figures 4 and 5**. In the US, over \$2 trillion of real estate debt is set to mature through 2026 with \$934 billion of this maturing through 2024. Another \$675 billion of real estate debt is set to mature through 2026 across the UK, Germany and France.

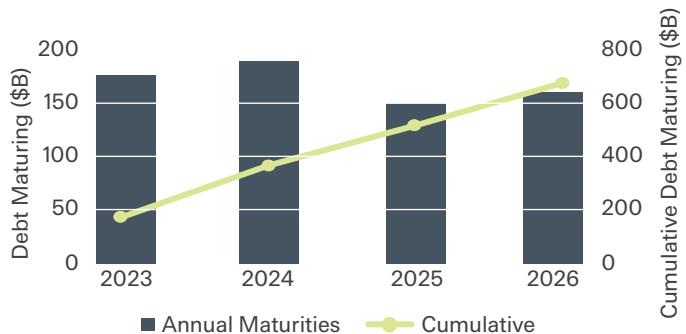
The current situation is not comparable to the post GFC period. There was a similar "wall of maturities," but zero interest rate policy led to an effective "extend and pretend" strategy facilitated by patient lenders. Central bank policy is now running in the opposite direction with interest rates on a "higher-for-longer" path. Banks are more motivated to collect and reinvest at higher rates, even though US regulators have asked the banks to work with borrowers.

FIGURE 3: US COMMERCIAL MATURITIES BY ISSUER



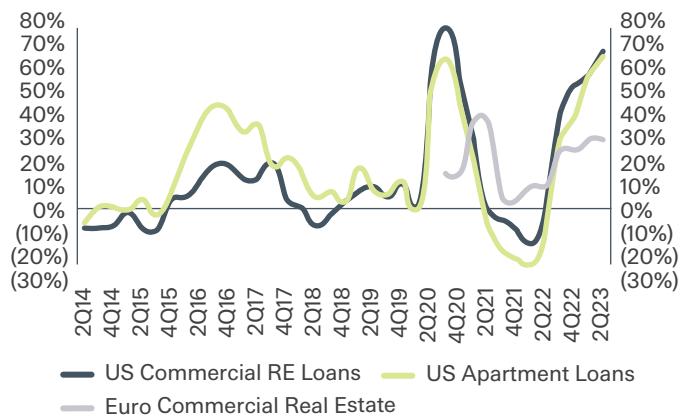
Source: Trepp The Year-End 2022 data as of Q3 2022; March 2023.

FIGURE 4: UK, GERMANY AND FRANCE COMMERCIAL MATURITIES



Source: PGIM data as of November 2022; March 2023.

FIGURE 5: BANKS TIGHTENING LENDING STANDARDS FOR COMMERCIAL REAL ESTATE LOANS



Source: US Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices and European Central Bank Lending Survey, July 2023.

Growing GP-Led Secondaries Market

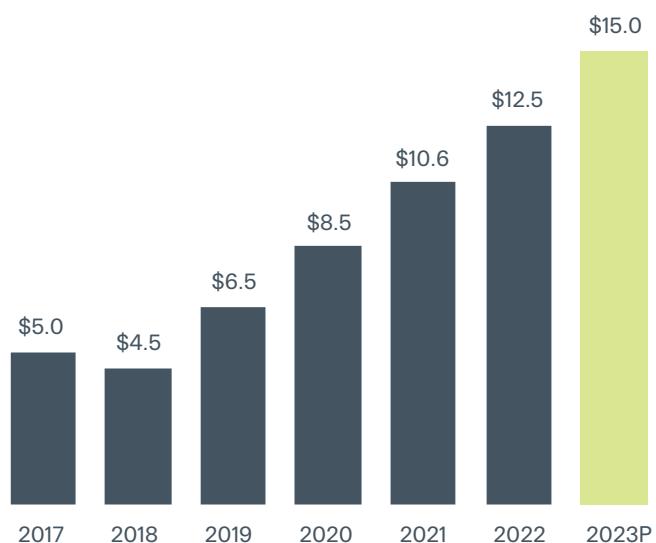
The GFC led to a more permanent role for real estate secondaries as a portfolio and liquidity management tool for institutional investors. Real estate secondaries volume has been growing consistently since the GFC, with most transactions now coming from GP-led secondaries.

TWO SOURCES OF SECONDARY SALES: LP AND GP

Secondaries sales can come from two sources with very different characteristics.

- Traditional or LP-led secondaries are typically driven by a limited partner's desire for liquidity and portfolio management.
 - They are generally sold via competitive auctions to enable the sellers to meet their fiduciary duty. The auctions put meaningful time pressure on bidders.
 - Since these sales are initiated by the LP to meet internal LP goals, the transaction tends to have limited support from the GP. This adds complexity to the process, and unless they have other sources of data, bidders often must act with limited data and insight on the GP's plans for the assets.
 - Transaction volume varies over time. Volume has been notably larger during cyclic periods in which:
 - LPs have become overallocated to real estate due to the denominator affect, and
 - distributions have diminished from their portfolios so they may need to sell otherwise illiquid interests in the secondaries market to generate liquidity to meet capital calls and fund their institutional obligations.
- GP-led secondaries are driven by the manager's perception that a capital infusion or a new investor benefits their assets or their platform.

FIGURE 6: GLOBAL REAL ESTATE SECONDARY TRANSACTION VOLUME (US\$ BILLIONS; 2023P = PROJECTION)



Source: Jefferies LLC, April 2023.

- Continuation vehicles enable the GP to retain assets that they believe can still have the potential to increase in value when LPs want to exit
- Other forms of recapitalizations help GPs take advantage of opportunities or to solve problems in their portfolios. As described above, liquidity problems are rising in today's market and are expected to drive much greater GP demand for secondary capital.
- GP-led secondaries can be privately sourced and negotiated, rather than purchased through competitive auctions, and tend to have less time pressure.
- They are often fully supported by the GP with detailed due diligence information.
- It is possible to structure the new interest in a variety of ways to accommodate investor and GP objectives, including investing as equity at a discount to market value, or as debt, preferred equity, or participating debt. Implementing tax efficient structures and resetting the GP's carry basis to improve alignment of interest are also common elements of GP-led secondary transactions.

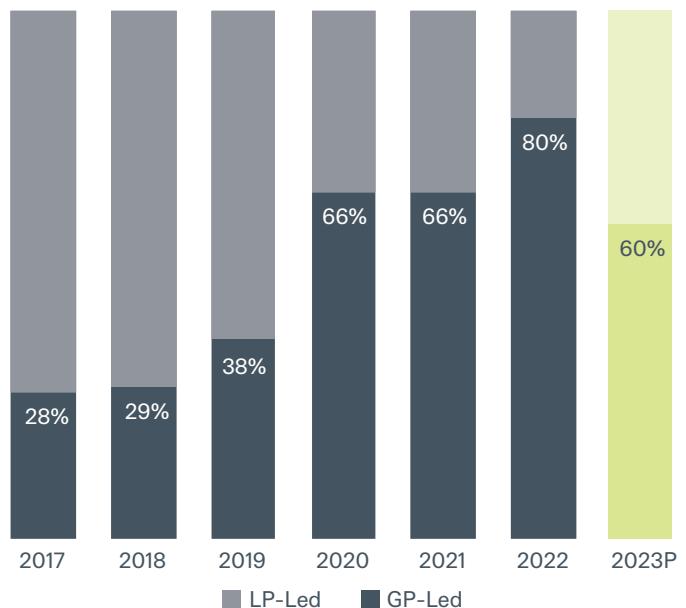
Since 2009, when SRE's principals developed this "special situations secondaries" approach, it has become a popular way to invest in secondaries, with a number of secondaries investors employing similar tactics after the LP-secondaries market volume began to wane beginning in 2016. As demonstrated in **Figure 7**, the GP led segment has grown from nascence to over half of total real estate secondaries market volume. Also, unlike heavily brokered LP-led secondaries, survey statistics may undercount GP-led secondary volume because GP trades are often privately negotiated, making them harder to track.

GP-LED SECONDARIES THROUGH THE MARKET CYCLE

The slow decline in property and fund values is likely to continue for some time. During this period, SRE believes that GP-led real estate secondary opportunities will emerge in the following ways:

- Opportunities to **help managers meet funding gaps and manage their balance sheets** are likely to expand as real estate markets move into a period of dislocation. In the wake of the GFC, the SRE team executed a significant number of recapitalizations where proceeds were used by the GP to pay-down debt, fund capital improvements or working capital needs.
- As larger funds attract an increasing proportion of the capital allocated to real estate private funds and overall deployment by LPs drops due to the denominator effect, small and mid-size managers are driven to seek **alternative solutions to fund their investment activities**, including recapitalizing their existing portfolios. These recapitalizations involve acquiring interests in the real estate vehicle at a discount or making a preferred equity or debt investment, with the common equity then subordinated to the fund's capital. The manager would then use proceeds to acquire additional assets.

FIGURE 7: SHARE OF REAL ESTATE SECONDARIES VOLUME BY TYPE
(% OF GLOBAL VOLUME; 2023P = PROJECTION)



Source: Jefferies LLC, April 2023.

- Opportunities to **help managers facilitate fund wind-ups through continuation vehicles** should become more prevalent with the impending downturn. While limited partners are often interested in winding-up long-dated legacy funds, capital market challenges may drive fund managers to extend the lives of their funds in hope of adding additional value to the remaining assets. This opportunity involves acquiring interests from limited partners seeking to exit real estate funds that are still holding assets at the end of their terms, and then backing management in the next stage of value creation for the funds' assets.
- Fund managers may find that their vehicles are overexposed to certain property types, geographies, or other diversification factors, and seek to **rebalance their vehicles' exposures** by selling a portion of interests of the assets in a direct secondary sale.

The Denominator Effect

Dramatic value declines for non-real estate assets can cause investors to be overallocated to real estate. This can trigger a secondary sale, and it can lead LPs to press GPs to sell assets or not deploy additional capital to meet liquidity needs, thus giving rise to a GP-led secondary.

This overallocation should moderate as traditionally-lagging real estate valuations catch up to other asset classes and as public equity values continue to rise. However, investors that need to strictly adhere to their defined allocations often do not have the tolerance to wait this out. **Figure 8** shows how varied returns across asset classes in 2022 took the sample portfolio from an on-target 10% allocation to real estate to an overweight 11% allocation.

The sharp increase in the redemption queue for ODCE funds, shown in **Figure 9**, is evidence that rebalancing due to the denominator effect has been occurring.

Conclusion

Higher interest rates are likely to lead to a bull market for GP-led real estate secondaries. GP-led secondaries allow GPs to complete worthwhile value add programs and potentially meaningfully improve returns, thus enabling them to live up to the latest market cry: Stay Alive until '25! They can also solve other problems created by LP's liquidity constraints resulting from the denominator effect and a cessation of distributions across their real estate portfolios resulting from the decline in transaction activity. LP secondaries can help LPs right size their allocations. An abundance of both types of secondaries affords investors greater selectivity at attractive price points with the ability to structure in beneficial ways.

FIGURE 8: ILLUSTRATIVE EXAMPLE OF THE DENOMINATOR EFFECT

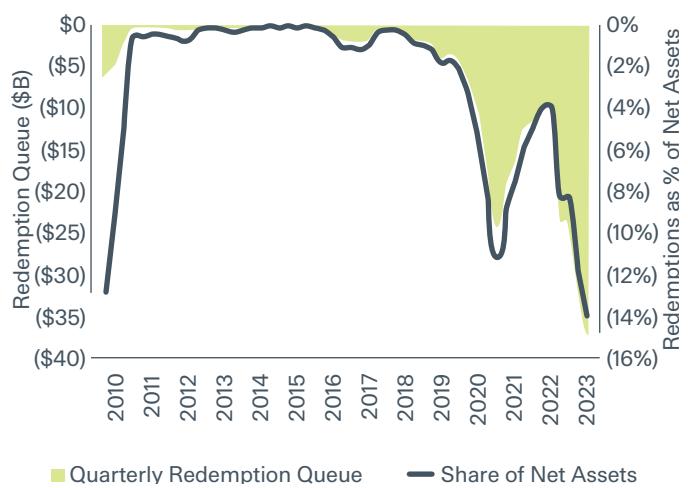
This shows the potential impact of earning 2022 index returns on a portfolio that was at its target allocations on 12/31/21. The result is an overweight to real estate.

Asset Class	Total Return 2022	Target Allocation	YE 2022 Allocation
Equities – MSCI ACWI	-18.0%	60%	59%
Bonds – Barclays US Agg.	-13.0%	30%	26%
Real Estate – NFI-ODCE	6.5%	10%	11%

OVERWEIGHT

Sources: MSCI, Bloomberg, NCREIF, March 2023.

FIGURE 9: NCREIF ODCE FUND REDEMPTION QUEUE



Sources: StepStone Real Estate Manager Surveys, data as of Q1 2023, July 2023.

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