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High Deal Prices Push Real Estate Managers to New Products
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Big private real estate fund managers are upping their focus on longer-hold, lower-return strategies – some for institutional investors, others for the advisor market – and more managers are likely to follow their lead, say market observers. Blackstone Group, Brookfield Asset Management, and Starwood Capital Group are among the large managers making such moves with recent product offerings.

The shift comes at a time when high real estate asset prices are crimping private equity-style fund performance, but also when inflows still are available for managers to grab from overseas institutions, such as sovereign wealth funds, and high-net-worth investors – groups that may find steady income and moderate-sized returns appealing.

The phenomenon is particularly active as real estate managers have been bracing for the high-flying returns of recent years in the asset class to flatten out, even as they have ample uninvested capital to deploy. A recent Hodes Weill & Associates-Cornell University survey of institutional real estate investors found 64% of respondents citing high asset valuations as their top industry concern, while their reported average 8.6% returns in 2016 were down from double-digit figures in previous years, including 11% in 2015.

“We’re seeing the pace of investment by managers has slowed down, and a lot of money committed to funds has not yet been called,” says Doug Weill, managing partner at Hodes Weill, a real estate advisory firm. “It’s harder to transact in this market today.”

Such pressures have led big managers to look beyond the typical closed-end private fund structure that invests across three to five years and returns capital after 10 years, says David Blatt, CEO at Capstack Partners, an investment bank and marketing firm.

“You have this significant appreciation in the market with respect to asset pricing and the issue of having to achieve certain yields, and that becomes much more challenging with a shorter time horizon,” he says. “In order to remain competitive, a way to solve for that is extending the duration of the investment – getting time to achieve those yields.”

That has pushed managers toward products with longer horizons, “permanent capital” structures that have no prescribed wind-down date, or funds with lower return targets – or a mix of such features. Those attributes also allow a manager to essentially pay more for assets than it would from a typical real estate fund, Blatt says.

“It still requires the same value analysis for that specific asset, but you’re willing to pay more because you have more runway to generate returns,” he says.

The model suits various longer-term products for different investors, such as core-plus real estate funds for institutions and real estate investment trust (REIT) or interval funds for individual investors, Blatt says.

“Your first movers are going to be the familiar institutional names, because they recognize the opportunity to diversify their investor base and capital base,” he adds. “Plus, they have the means to do it. [Targeting] the retail investor… requires time, patience, staff, and resources.”

Recent examples in the market indeed involve big brands, including Blackstone’s $5 billion real estate investment trust launched last year for high-net-worth investors, which has led non-listed REIT sector sales all year, as well as its core-plus real estate strategy, which has shot up to $18 billion in just four years. Starwood jumped in last month with its first non-traded REIT, a $5 billion offering that will invest in income-oriented commercial real estate equity and debt deals.

And Brookfield is planning a trio of such longer-range products for institutional investors, including a “private perpetual core-plus” U.S. real estate fund for which it has raised $2 billion. It has outlined plans for that product family to eventually exceed $50 billion in assets, alongside infrastructure and renewable energy funds that would have similar longer-duration formats and matching $50 billion target sizes.

“I would say that over the next five to seven to 10 years, as long as we’re in a low interest rate environment, this business is going to expand exponentially,” Brookfield CEO Bruce Flatt said during an August earnings call.

Managers are responding to demand from investors for these products in many cases, Weill says. “They talk to clients and hear, ‘Can you do something with less risk and a longer hold?’” he says.

But other real estate managers may soon join them. Middle market firms are inquiring about starting up such strategies, particularly “adjacent” offerings to established product sets, Weill says.

And smaller players are seeking partners such as Capstack to help structure and distribute longer-range products, Blatt says.

As these products gain ground, a pattern of paying more for real estate deals could continue, Blatt adds. “That ends up skewing pricing,” he says.

And if more foreign capital and retail investor money flows in, the new segment could keep rolling, he says. “It’s conducive for longer-duration vehicles,” Blatt says.

Domestic institutional investors already had been shifting out of core real estate funds toward higher-return value add strategies for several years as high valuations for properties have impacted performance, says Greg MacKinnon, director of research at the Pension Real Estate Association.

“Investors are asking how they can get the same risk-return combo in real estate they [had before],” he says. “There’s a bit of a look around for more returns than the core markets are offering.”

But even those investors may soon look at longer-range investing concepts, whether in open-end, perpetual, or joint venture vehicles, Weill says. “Investors want to see their money put to work and stay at work,” he says. “It’s a topic we hear more and more about.”