PORTFOLIO ADVISORS LLC

Real Estate

# The Post-Pandemic Case for Secondaries is Strong

**Despite the disruptions of the COVID-19 pandemic, the benefits of secondary investing in private markets, including real estate, have remained. Indeed, similar to many other areas of the economy, the pandemic has accelerated several positive trends already in place within real estate secondaries. The result is a wider application of the transaction type and a renewed focus on the advantages for both private real estate fund investors and their general partners.**

*The economic dislocations brought on by the pandemic have again highlighted the complexities inherent in managing large pools of illiquid private real estate assets, much like the Global Financial Crisis ("GFC") did just over a decade ago. Back then, pressures on the primary market catalyzed increased interest in secondaries, which were still considered a strategy of expediency instead of a tool for long-term portfolio management. This time around, a new crisis has again placed a spotlight on the secondary market for partnership interests, but the market today is dramatically more sophisticated, with greater awareness, more flexibility, and better solutions for a broader mix of challenges than ever before.*

This trend was well underway prior to the pandemic. Real estate secondary transaction volume was less than $2 billion in 2009, the same year private real estate fundraising for new, primary funds plummeted to $55 billion from $149 billion the year before[1]. Since then, however, real estate secondary transaction volume has grown steadily, reaching more than $7 billion in 2019[2]. Impacted by the pandemic, 2020's real estate secondary transaction volume dropped sharply as net asset values dropped significantly and the bid/ask spread between asset owners and secondary buyers reached peak levels.

We anticipate that transaction volumes will return to their long-term upward trend as asset prices stabilize and the bid/ask spread narrows. Our outlook for real estate secondaries remains strong as the pandemic fades from the headlines. There are a number of factors underlying our optimism:

➤ The maturity of the market has evolved to where participants on both the buy- and sell-side can tailor transactions to meet precise goals and objectives. Historically, a standard secondary transaction was characterized by a limited partner (LP) who needed liquidity selling a fund interest at a discount to net asset value to an investor who could provide that liquidity. These are usually private arrangements that need consent from the general partner (GP), but they are very much LP-driven. Now, LPs are utilizing secondaries as a core mechanism to manage exposure to real estate, improve asset or fund quality, reallocate or re-balance portfolio concentrations, and/or relieve unfunded commitments.

**June 2021**

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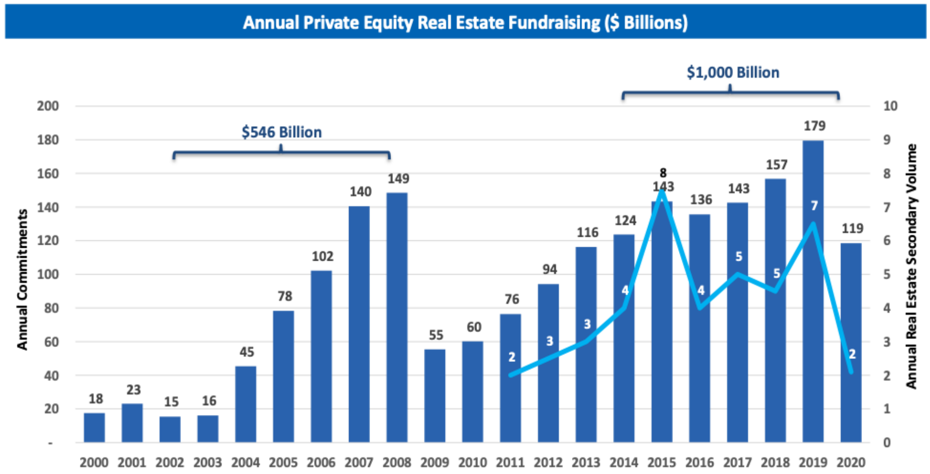
➤ GPs are utilizing secondaries to recapitalize assets when a fund's lifespan may need to extend beyond its original term, or if the fund's asset re-positioning and liquidation plans were delayed or stopped by the pandemic. Furthermore, fund sponsors are increasingly structuring secondary transactions to bring more long-term capital into their businesses for liquidity or growth reasons.

➤ The sheer increase in the opportunity set defined by the amount of real estate fundraising suggests healthy secondary activity going forward. As a derivative of the primary market, real estate secondary transaction volume has historically averaged around 2-3% of the total private equity real estate primary fundraising per year. As illustrated nearby, $1 trillion has been raised for primary real estate funds in the years prior to the pandemic – nearly twice the level of the pre-GFC cycle, which acted as a catalyst for secondary volume. This indicates the real estate secondaries ecosystem will continue to expand.

Note, too, that despite the headlines, distressed situations are only part of the equation. Yes, COVID-19 has stressed the market, but in the wider arc of real estate's status as a long-term asset class, the pandemic's impact may be relatively short lived. Instead, the distress has been felt elsewhere, less focused on properties necessarily but structurally on investors, funds, managers, etc. and the ways in which they interact. This stress has contributed to changes in how market participants view secondaries and the opportunities they present.




*Source: Portfolio Advisors, Preqin, Greenhill (1)*

## The Growing Advantages of Real Estate Secondaries

As with many other investment opportunities, real estate secondaries can offer different advantages to different investors, depending on the intent of the transaction. A few key attributes of these transactions:

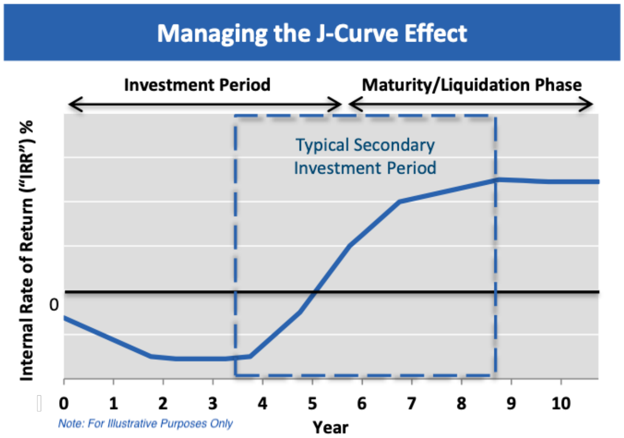
**1. Asset quality**: Many real estate secondary opportunities involve older vintage value-add or opportunistic funds where underlying properties have undergone much of their transitional business plans and now do not necessarily exhibit similar risk profiles. In a secondary, the investor is essentially buying assets later in the cycle, therefore allowing the repricing of those assets and often acquiring assets in the range of core plus or lower value-add level risk.

**2. Benefit of the rear-view mirror**: Hindsight is a particular advantage of secondaries – the ability to correct for previous value assumptions and avoid the need to take unfunded risk. Secondaries offer the ability to diligence and price funded assets, essentially going back in time for exposure to assets from 4-5 years ago and knowledge of what may have transpired.

**3. Shorter duration**: Related to #1, a secondary is by default a shorter-duration asset. Buying an asset or LP interest after its initial funding has the potential to generate attractive returns over shorter periods for less risk. In real terms, this suggests shorter holding periods, greater yield and earlier liquidity.

**3. J-curve mitigation**: Secondaries can help offset the impacts of the J-curve effect on broader portfolios, since they are often purchased at meaningful discounts to NAV, and the typical secondary investment period occurs several years after inception, which can counter the flat line performance encountered by many funds early on.

**4. Diversification:** Secondaries can provide enhanced portfolio diversification through the acquisition of back-dated vintage year exposure to a broad array of sponsors, geographies and property types.




**5. Inefficient marketplace**: For all their advantages, secondaries are still a fairly opaque corner of the market with a lack of readily-available information and a dearth of truly experienced participants. Those with deep access to real estate funds, and familiarity with the secondaries ecosystem and structures, have material information and expertise advantages, and are thus best equipped to make the most out of these asymmetries.

## The Path Forward

We think the widening applicability and value offered by real estate secondaries, coupled with post-COVID 19 acceleration of demand, means transaction flow should continue to rise. However, goals like asset diversification, portfolio optimization, liquidity and recapitalization are not achieved overnight; success requires time, experienced teams and relevant information. This is particularly true for those seeking to take advantage of pandemic-related dislocations or who have a need to move rapidly due to structural pressures.

Accordingly, we think the next phase of real estate secondary growth will be led by specialist managers – who have developed extensive relationships in the marketplace, information access, and structuring experience. Portfolio Advisors, for instance, has a proprietary database tracking details and data on hundreds of funds and sponsors, lending an information advantage that can translate directly into more accurate transaction pricing.

We also believe the prevalence of GP-led real estate secondaries will increase. In this sub-sector of the market, understanding the underwriting requirements of such transactions will be key, as will relationships allowing for direct conversations with sponsors on their fund capitalization, performance and investor needs. Companies with broad private market platforms and direct co-investment capabilities, which can satisfy both conditions, will have a clear advantage in this environment.

Finally, we believe the middle market will be an area of particular interest for real estate secondaries going forward. This segment is more fragmented and accurate data is much harder to come by, so the information advantages mentioned earlier are greater. Meanwhile, competition is lower, so pricing is less efficient, and relationships are even more crucial to sourcing high-quality deal flow. Added together, we think these factors suggest the opportunity set for middle-market real estate secondaries post-pandemic will be robust, and it is an area of focus for us.

## Key Conclusions

The real estate secondaries market entered the COVID-19 pandemic with several trends supporting further growth, including a shift toward flexibility, liquidity and more sophisticated management of LP and sponsor interests. The dislocations, delays, and structural pressures of the pandemic have served to catalyze these trends, pointing to the need for a broader range of solutions. Much like in the aftermath of the GFC in 2009, we don't think this market goes backward; post pandemic, wider acceptance of the real estate secondary market by limited partners and fund sponsors alike will combine with increased utility and cement the strategy as a core solution set within the private equity real estate ecosystem. ■

## Endnotes

1. Preqin Pro. Database accessed January 7, 2021. Preqin, Ltd. Greenhill Cogent Partners, “Secondary Market Trends & Outlook, January 2021,” www.cogent-partners.com

2. “Financial Sponsor Secondary Market 2019 Year-End Review”, Lazard Frères & Co. LLC, pg 10

## Chart Citations

1. Preqin Pro. Database accessed January 7, 2021. Preqin, Ltd. Greenhill Cogent Partners, “Secondary Market Trends & Outlook, January 2021,” www.cogent-partners.com

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