WealthManagement.com

cokada/iStock/Getty Images

Real Estate [1]>Investment Strategies [2]

Is Dry Powder in the CRE Space Ready to Move Off the Sidelines?

Funds and REITs that built up massive war chests are taking steps to make deals despite current uncertainties over optimal real estate pricing.

Beth Mattson-Teig [3] | Aug 21, 2022

Many well-heeled real estate investors pushed pause on buying assets in recent months to get a better read on how pricing is shifting [4] across all property types and how they might have to alter strategies [5] or restructure capital stacks to move deals forward. Once pricing stabilizes, many market insiders believe all-cash and low-leverage buyers are best positioned to be the first movers off the sidelines.

Sales activity has slowed over the past few months, and many brokers are seeing less for-sale inventory on the market. Sales data for June shows a 4 percent year-over-year dip in transaction volume to $68.4 billion, according to MSCI Real Assets. And many are bracing for a bigger decline in the July sales data.

“We are seeing a bit of a wait-and-see approach now, but I don’t expect to see that in the back half of the year. There is still a lot of money that is trying to get into solid assets, especially the industrial and multifamily space,” says Erik Foster, a principal and head of industrial capital markets at Avison Young in Chicago. “Those folks who don’t use leverage as much are the ones that are likely going to be the ones to deploy their capital first, and potentially more aggressively,” he says.

Although not all investors have hit the brakes, buyers are moving more cautiously. “There is plenty of capital out there, but it is more selective,” says Chinmay Bhatt, a senior managing director and founding member of Berkadia’s JV Equity & Structured Capital group.

According to PwC [6], dry powder levels remain at all-time highs, with increasingly higher levels being raised through private vehicles such as non-traded REITs and private equity funds. Following a record year of capital raising in 2021, Robert A. Stanger & Co. reported that non-traded REITs raised $12.2 billion in capital [7] during the first quarter of 2022, with the largest share continuing to go to Blackstone ($7.8 billion), followed by Starwood ($2 billion). Meanwhile, according to Preqin [8], North America-focused private equity funds across asset classes, including real estate, held $1.85 trillion in dry powder as recently as September 2021.

Cash and low-leverage buyers in particular are going to be less impacted by higher debt costs. For example, the average leverage across the more than 3,200 properties and 27 funds that make up NCREIF ODCE Index is 22 percent. REITs also remain relatively well-capitalized [9]. Many REITs de-levered following the Great Financial Crisis and also can tap the bond market for debt rather than relying on traditional property-level mortgage financing.

Changing capital stack

Another byproduct of rising interest rates and uncertainty creeping into the market is that lenders are pulling back on leverage. “While most investors do not want to reduce leverage, some have because of the change in value for office assets,” says Russell Ingrum [10], vice

chairman of capital markets at CBRE. That being said, the market is at the beginning of de-leveraging, and it is not equal. “All assets and all markets are not seeing the same outcomes. The worst affected are markets with significant increases in vacancy,” he says.

In many cases, leverage has dropped below 70 percent, which is creating demand for alternative capital sources to fill that gap with subordinate debt, equity or alternative finance sources such as tax credits.

Bhatt and his team focus on the equity part of the capital stack, including sourcing JV equity and preferred equity [11] for multifamily, student housing, single-family rentals and build-to-rent communities. In most cases, they’re casting a wide net, often reaching out to double the capital sources, to find the right investor. “While people are being a little more selective in the joint equity space, deals are still getting done,” he says.

Joint venture capital has seen a slight shift in cost of capital. A few months ago, value-add and core-plus multifamily deals were being done with 8 percent to 9 percent preferred returns in waterfalls and now that has gone back to 9 percent to 10 percent and above. “So, there has been some change, but it hasn’t been dramatic,” says Bhatt. “I would say that people are not willing to take lower returns today in the joint venture world. If anything, it is the same or higher.”

Preferred equity also might be a good solution for some sponsors as the cost of capital is fairly competitive with subordinate debt. Over the last 30 years, pricing of that preferred equity capital has ticked slightly higher, but not as much as debt costs have increased. There is a lot of preferred equity in the market, and that competition has kept pressure on pricing. “There are dedicated preferred equity pools of capital and there also are joint venture pools of capital that are now looking to put money out on the preferred equity side to get money out the door,” says Bhatt.

The bar to get a deal through an investment community today is higher, notes Bhatt. “However, there is still great real estate out there to buy and very relevant projects that should be built, and it’s a function of finding the right strategy on the debt side, as well as the right group on the equity side to piece together the puzzle to make it happen,” he says.

Buyers look for creative solutions

Buyers also are finding some creative workarounds to higher interest rates, including looking at more loan assumptions. Some of the fixed-rate debt executions that were put in place in 2021 or 2020 now look attractive in light of today’s higher rates. “What we’re seeing is that our developer/operator clients, as well as our equity sources, are willing to get creative to make deals work,” says Bhatt. For example, Berkadia is currently working on lining up financing for a large portfolio deal where a large part of the capital stack will be an assumption of existing debt.

However, the challenge is that existing low-cost debt may be an incentive for owners to hold onto existing assets. “Most owners we are speaking with are talking to us because they have a near-term debt expiration themselves, so they are unable to pass along their current cost of debt capital,” says Ingrum. Especially for office owners who have term on their loan, it makes more sense to wait for a better environment, he adds.

Another important point to note is that higher debt costs are not the only factor causing some buyers to push pause on acquisition strategies, says Ingrum. “While investors are tapping on the brakes, it is more nuanced and likely due to recession rather than interest rate fears,” he says. In particular, institutional capital has been pivoting away from office for two years due to pandemic uncertainty. “You can price through interest rates, but it is difficult to price through a recession,” he says.

Low leverage buyers and cash buyers have largely retreated to other product types and that decision has nothing to do with interest rates. It is all based on concerns about the office market generally and concerns about relative performance to the ODCE Index, says Ingrum. “If your peers are migrating to industrial, multifamily and single-family rentals, then you feel compelled to do the same,” he says. However, as institutions have pulled back from office, it is opening up buying opportunities for private capital and 1031 investors, he adds.

Another positive for the transaction market is that buyers and sellers are starting to see prices move. The list prices from a few months ago compared to where properties are actually being put under contract and closing today, especially for value-add deals, has declined between 8 percent to 15 percent, notes Bhatt. Those discounts are helping to offset the higher capital costs. “Sellers for the most part are starting to realize that we’re in a different marketplace today, and if they want to transact, it’s going to be at a different number than what they had in mind a few months ago,” he says.

Source URL:https://www.wealthmanagement.com/investment-strategies/dry-powder-cre-space-ready-move-sidelines