Raising the Bar

Institutional investors favor multifamily and industrial, but they are investing across the spectrum of risk profiles and showing an interest in non-gateway markets and alternative property sectors.

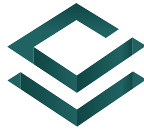
By **Beth Mattson-Teig**

Despite market turbulence caused by rising interest rates, institutional investors remain firmly committed to maintaining, if not increasing, portfolio allocations to commercial real estate.

Results from the first *WMRE* Institutional Investor Survey (brought to you by Yardi) estimate current institution and pension fund allocations to real estate at an average of 14.6 percent. Nearly half of survey respondents (48 percent) see allocations increasing, while 45 percent said allocations are holding firm. Only a minority of 7 percent see institutions reducing allocations to real estate.

"Coming into 2022, we were continuing to see a lot of robust sentiment and allocations towards real estate. That was in part driven by the fact that, on average, institutional investors across the board were under-allocated versus their targets," says Bernie McNamara, head of client solutions at CBRE Investment Management. Recent shifts in valuations in the stock and bond markets could be skewing allocation numbers a bit more heavily towards real estate. However, even that "denominator effect" doesn't necessarily get investors to their target allocations for real estate, notes McNamara.

Investors are putting new investment into real estate on hold given the uncertainty in the market. "The pauses are most pronounced among those institutions that have liquidity considerations or near-term liability considerations, and they are just trying to manage towards those," says McNamara. However, that pause in deployment of capital is likely temporary. There has not been a fundamental change in institutional investors' allocations to real estate or a desire to underweight real estate because of the current environment, he notes.



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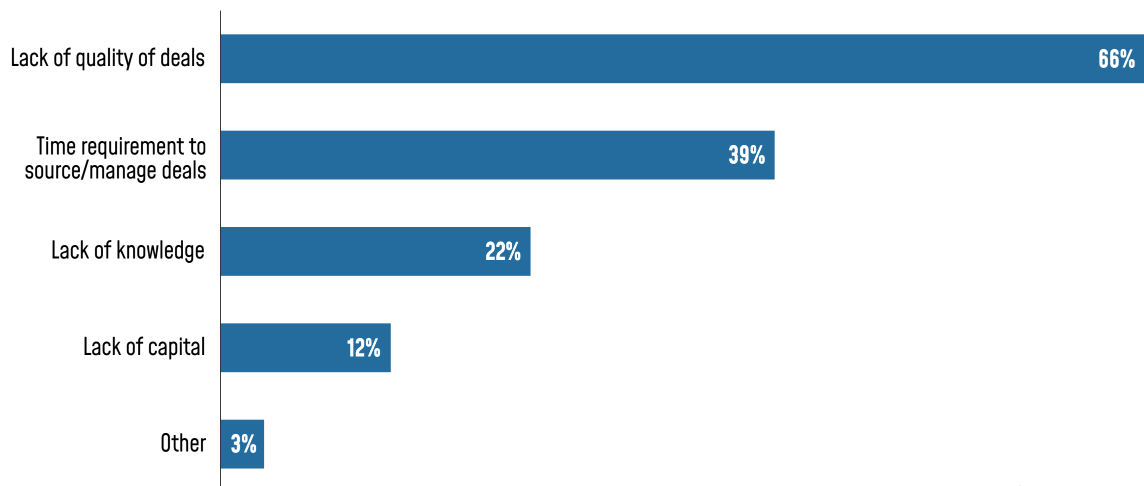


"Institutions are looking at the denominator effect of their overall portfolio and trying to figure out what just happened," agrees Peter Ciganik, senior managing director, head of capital markets, at GTIS Partners, a New York-based real assets investment management firm. The stock market has seen a sharp drop in value this year. Obviously, when the value of equities goes down, real estate being more stable, represents a bigger chunk of an institution's overall investment portfolio, he says.

GTIS Partners has seen a few of its institutional investor clients that have maxed out their allocations to real estate due to the drop in stock market values. "They are now standing back and trying to figure out whether that shift is temporary, and they can continue with their real estate plan, or do they need to reconsider," says Ciganik. "So, I would say that institutions are moving slower and are in the wait-and-see mode as they figure out their denominator effect."

Hurdles to reach targets

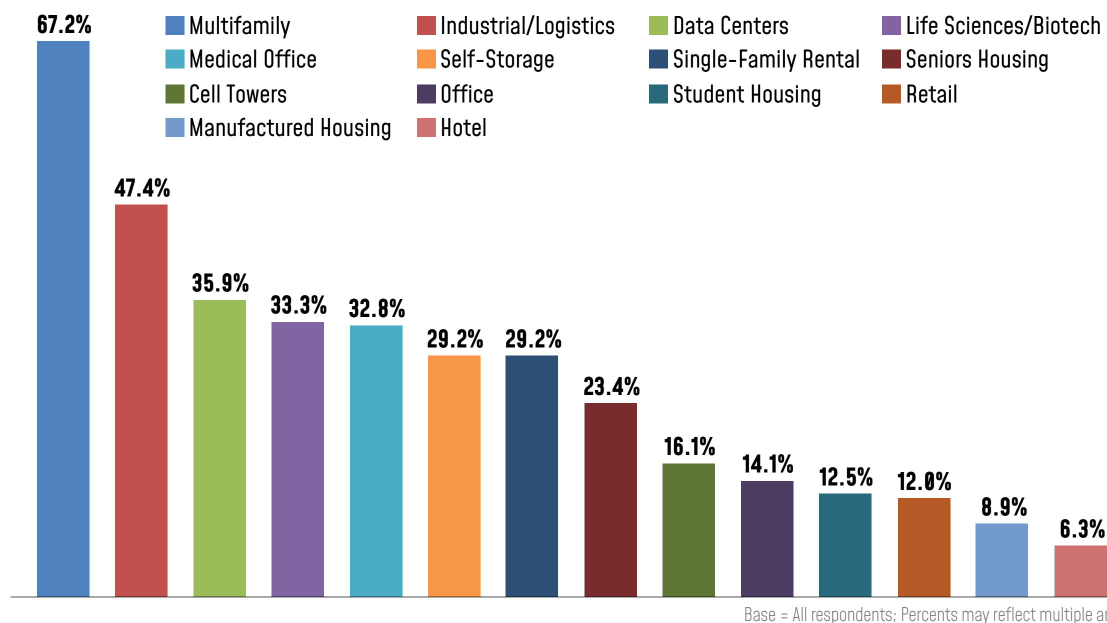
The *WMRE* survey findings for rising allocations align with other industry surveys. According to the ninth annual Hodes Weill & Associates and Cornell University's Baker Program in Real Estate's Institutional Real Estate Allocations Monitor, pensions, sovereign wealth funds, insurance companies and other institutions continue to look to real estate as an important portfolio diversifier, hedge against inflation and source of stable income. The survey found that target allocations to real estate increased for the eighth straight year, inching 10 basis points higher to 10.7 percent in 2021.

WMRE survey respondents said the two biggest factors likely to have the greatest negative impact on institutional investors' allocations to real estate would be rising interest rates (54 percent) and a real estate downturn (39 percent). The 10-year Treasury has increased roughly 140 basis points year-to-date to hover at about 3.0 percent as of August 23, and the Fed is expected to raise the federal funds borrowing rate again in September in its attempt to curb high inflation.

The percentage allocation that institutions say they want to be invested in real estate does seem to creep higher every year, notes Jeb Belford, a managing director and chief investment officer at Clarion Partners, a global real estate asset management firm with $81.4 billion in AUM. "However, because the base is so big, even small changes to that are meaningful," he says. For example, even moving a target allocation by 50 basis points can translate into hundreds of millions of dollars for some institutions. Likely, those increases are occurring because real estate is being viewed as a more trusted asset class and an asset class that is more appreciated for the benefits it provides in a mixed asset class portfolio, he adds.

Institutions have been struggling to reach target allocations in recent years. According to the Hodes Weill/Cornell report, 67 percent of institutions are under-invested relative to target allocations by an average of 230 basis points. According to the *WMRE* survey, the two biggest hurdles credited for not being able to meet real estate investing goals are lack of quality deals (66 percent) and the time requirement to source/manage deals (39 percent). Lack of knowledge was considered to be another hindrance by 22 percent and lack of capital by 12 percent.

"Buying and selling assets is not a momentary thing in our space. It's not like we can go to the computer and buy $4 billion in Coca Cola stock in one second. It takes time to deploy the capital," says Belford. For example, capital committed to a sponsor of a closed-end fund may take anywhere from six months up to 24 months to be called. So, there is also an element to under allocations that capital has been committed,



but not drawn down yet, he adds. It also takes time to conduct due diligence on the many options of investment opportunities and fund managers.

Multifamily, industrial remain favored sectors

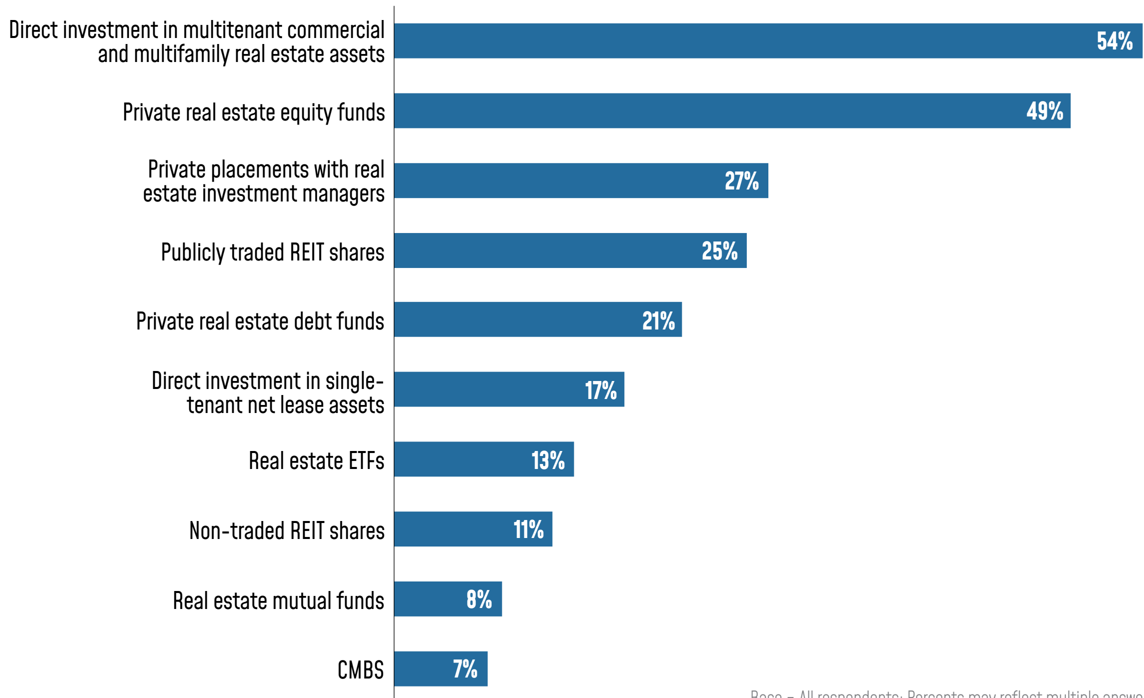
Institutions tend to be overweight in sectors that have strong demographic drivers. Survey results show that institutions are most likely to prefer investing in multifamily (67 percent) and industrial (47 percent), followed by data centers (36 percent). "Since the GFC, multifamily and industrial have had tremendous demographic tailwinds, and COVID added after-burners," says Jeff Adler, vice president, Matrix at Yardi. That sentiment is also reflected in sales data. Multifamily assets represented about 41 percent of all property transactions with $154.6 billion in sales during the first half of 2022, while industrial had the second highest volume at $74.6 billion, according to MSCI Real Assets.

Although office and retail have traditionally been considered part of the four major food groups for institutional investors, both office and retail rated low by respondents at 14 percent and 12 percent, respectively. The general premise driving demand for office was that people needed to go to one central physical location to do work, notes Adler. "COVID blew that apart. We're still in the early innings of trying to figure out how to put all of that back together, and it's not going to be the same as it was," he says.

However, it is noteworthy that within the office world, there are two niches that are absolutely outperforming the general office market: life sciences and medical offices, notes Adler. Life sciences rated favorably among one-third of respondents and medical offices among nearly one-fourth. The challenge for institutions is that it can be difficult to access life sciences as it's a very small segment of the overall office stock. Medical offices are also performing well with strong demand drivers due to the baby boomer population that likely will have more demand for medical services as they get older. Although retail rated low in the survey, grocery-anchored centers continue to perform well, while the mall sector is working to reinvent itself and it does show signs of stabilizing, notes Adler.

Views on preferred property types also might reflect the evolution occurring within real estate portfolios. Traditionally, 1.0 executions were overweight in office and retail, whereas 2.0 executions have a greater emphasis on logistics and residential. According to McNamara, the focus for many institutions is currently on 3.0 portfolio strategies that focus on increasing allocations to logistics and residential as well as other growth sectors, such as self storage and seniors housing.

When asked to select the three investment vehicles institutional investors are most interested in, survey respondents rated direct investment in multi-tenant commercial and multifamily real estate assets the highest at 54 percent, followed closely by private equity real estate funds at 49 percent. Private placements with real estate investment managers and public REITs also rated favorably among 27 percent and 25 percent of respondents. Those vehicles least in favor were real



estate mutual funds at 8 percent and CMBS at 7 percent.

Institutions typically view funds as an efficient way to get diversified access and exposure to certain sectors and subsectors, and then use direct investments where they have more control as a complement to those fund strategies, notes McNamara. In terms of other formats that are on the rise, more investors are taking an "all of the above" approach that helps them to reach target allocations, he says. For example, that might include deploying capital into public REITs. There can also be both tactical and strategic reasons why investors are embracing different vehicles, such as using public REITs to get access to growth sectors that might be harder to access at scale through direct investment, such as life sciences or single-family rentals, he says.

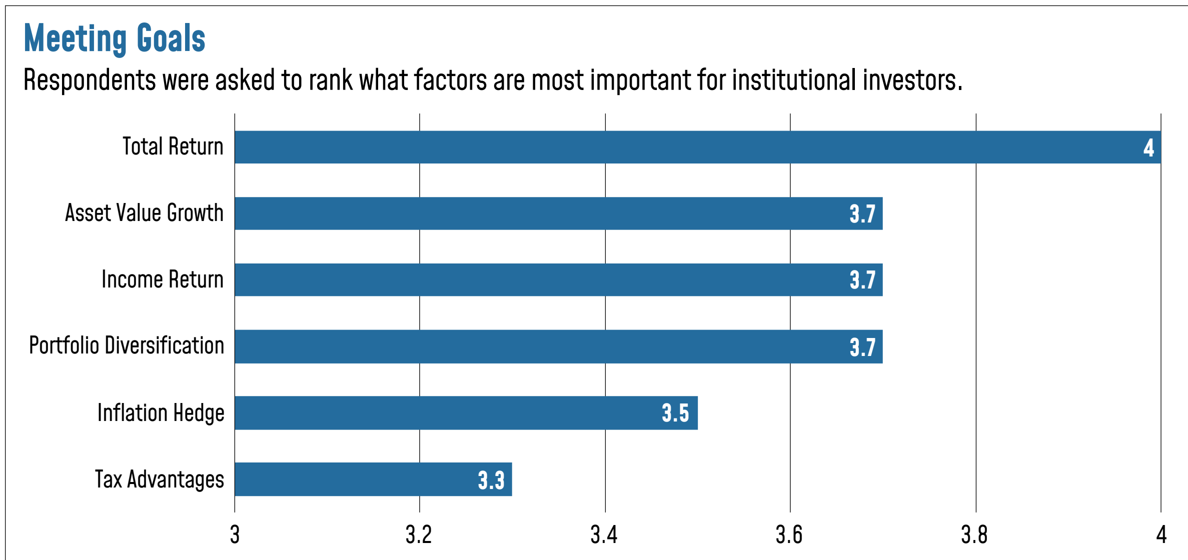
Capital focuses on primary markets

Institutions have traditionally gravitated towards the six gateway cities—San Francisco, Los Angeles, New York City, Boston, Washington, D.C. and Chicago. However, investment has expanded into top 25 markets, especially high-growth areas of the Sun Belt that offer more affordable living. "What COVID did was really rip off the cover and accelerated the movement of people and accelerated the movement of institutional money to those places where people were already moving," says Adler.

Despite the pandemic, institutions have a clear preference for investing in primary markets at 4.2 as compared to 3.2 for secondary markets and 2.3 for tertiary markets.

"Gateway markets are coming back with a vengeance," says Ciganik. Apartment rents in New York City and Miami are hitting record levels, because less new product has been built. That being said, institutions are willing to look at markets across the board, and markets that used to be considered secondary or even tertiary are definitely on investor's radar now, notes Ciganik. Markets that would have been considered secondary, such as Phoenix or Denver, are garnering more attention from institutions. That is in part driven by the growth story in those markets, as well as the desire to capture greater yield. Some institutions are also moving into what would traditionally be considered tertiary markets.

Part of that shift in institutional capital into non-gateway markets also reflects the evolution occurring within secondary and tertiary markets. For example, 20 years ago Seattle would have been considered a secondary market. Today, many consider the city to be a gateway market as it is home to major companies such as Amazon and Microsoft, says Ciganik. "I think that will happen to a handful of other places, and we like to be where the puck is going so to speak based on demographic and job trends," he says. Over the past decade, GTIS has focused on the Sun Belt and other "talent magnets" like Denver and Charlotte. That was a result of the demographic-driven change that has been occurring over the past



decade, which further accelerated during COVID, he adds. GTIS Partners has a U.S. residential strategy that invests in for-sale homes, single-family rentals and apartments, as well as an income strategy that includes multifamily, office and industrial logistics.

Institutions invest across risk spectrum

Generally, there is not a strong variance in views on institutional investing strategy. The focus on core, core-plus, value-add and opportunistic were all in a fairly tight band with a mean score between 3.6 and 3.4. The one sector that was noticeably less in favor was buying distressed assets, which rated an average score of 2.8.

There are definitely those institutions that are higher risk minded and those that are lower risk minded, as well as institutions that play across the whole risk spectrum. Strategies fluctuate and the preference for different strategies can move depending on views of the current economic cycle. "Obviously, short-term and long-term factors can significantly affect investor behavior," says Belford. The longer-term trend is that core and core-plus strategies have increased. At the same time, there are many institutions that have a significant portion of their real estate allocation invested in higher risk strategies. Overall, all of these strategies are very robust and very deep, he adds.

Survey results show mixed opinions on the annual rate of return that institutional investors are looking for from their real estate investments. Forty-five percent of survey respondents said the expectation was between 10 percent and 14 percent, while 43 percent said return expectations are between 5 percent and 9 percent. Although double-digit returns are not realistic for core investors, they are achievable for institutions that are building a core-plus strategy or are working towards blended returns from a mix of core, core-plus, value-add and opportunistic investments.

According to McNamara, many institutions build towards a core-plus profile, although some have a barbell with a foundation of core and then value-add and opportunistic investments. "That is still very prevalent portfolio construction, but you're seeing more investors who will get to that blend of core and value-add or opportunistic through core-plus vehicles that do it all in one vehicle execution," he says. Double-digit returns are also achievable with more of those 3.0 investment strategies that are investing in growth-oriented alternative sectors, he adds.

While *WMRE*'s annual surveys of high-net-worth investors consistently show that the most important factor when investing in CRE hands down is the preservation of capital, for institutional investors, the most important factor is total return. Total return rated a 4.0. Portfolio diversification, income and asset value growth also all rated high at 3.7.

According to Belford, one of the most important factors for institutions investing in real estate is that the asset class has a very different risk-return profile than other assets such as stocks. Real estate tends to be less volatile and more consistent. The return characteristic is also meaningfully different over a long period of time versus equities and debt. "From a return generation style perspective, it's a diversifier in your portfolio, and that's really attractive for people that are creating sophisticated mixed-asset portfolios," he says.

In addition, 53 percent of respondents are focused on the overall deal return compared to 10 percent who are more focused on current return, while 37 percent said both are important. That focus does depend on the type of institution and their specific investment objective, notes Adler. For example, a pension fund that has a long obligation is going to look at total return over a longer horizon. Depending on portfolio construction, an institution might need current cash flow. If an institution, whether it is an endowment or a life insurance company or some other type of institution, needs current

cash flow, it's going to lead them to perhaps a different type of investment with a different return profile. "That's why real estate is great, because there is a deal and a place for everything," says Adler.

Despite the recent period of high inflation, respondents rated CRE as a hedge against inflation as moderately important at 3.5. Real estate can be a good hedge against inflation depending on the property type. Assets that have shorter lease terms, such as multifamily, hotels and self storage can more easily reset rents to capture inflation versus the longer team leases in sectors such as office and retail. "Inflation is a bigger risk, making CRE a more important piece of a long-term portfolio strategy," wrote one respondent.

Institutions are demanding more tech

Real estate has always had a bit of a reputation for being "old school" when it comes to embracing technology. However, that image is changing. A number of factors are driving technology further into the industry, ranging from the explosion of proptech and fintech to growing demand from institutional clients for more real-time data and analytics to drive decision-making. However, the survey responses related to the use of technology and tools for institutional investors show definite room for improvement.

Almost two-thirds of respondents (63 percent) said they still use Excel or spreadsheets to calculate promotes, waterfalls and other structures as compared to 35 percent who use an investment management system.

"In our business, when people ask us who our main competitor is our first answer is always Excel," says Chris Barbier, senior director, investment management, at Yardi. Some fund managers or sponsors stick with Excel due to their comfort level, while others feel that they are doing something unique that cannot be standardized, which is why they are slow to move to an investment management system. However, Yardi is seeing a shift to investment management systems occurring due to the end-to-end process efficiency such systems offer.

"What we hear from clients is that investment management systems allow firms to take on more investors and more investments with less staff because it is a more automated process," says Barbier. Investment management systems are a seamless way to connect information from the asset level through the investment structure out to the investor without having to move data or re-key data into different spreadsheets or applications. In addition, investment management systems don't run the risk of having that calculation error buried somewhere in the dark abyss of a spreadsheet that has been compounding over time, says Barbier.

When asked what additional functionality respondents would like to see added to investment management systems, additional comments include more real-time market data and the ability to incorporate data science into dashboards to determine where best to place digital marketing emphasis.

A majority of respondents (67 percent) said their companies do not use real estate investment accounting software, while 22 percent said their company does use such software and 11 percent were unsure. Among those that do currently use accounting software, the biggest functionality respondents like is that it integrates with property management systems (72 percent), automates financial consolidations (58 percent), manages and tracks capital activity (56 percent) and calculates performance metrics (51 percent).

Nearly half of respondents (53 percent) said their company does not use a real estate investor portal compared to 43 percent who do. Among those who do use an investor portal, the most popular functionality is investor access to documents and reports (75 percent), integration with investment management systems (49 percent) and an interactive dashboard with investment positions and accessible documents (46 percent). Investors are asking for more information than ever before, and they also expect it quicker with information that is readily at their fingertips, notes Barbier. "Some of the specific features they value varies depending on the client, but it's all about providing access to information in whatever way those investors want it," he says. ■

Survey methodology: *The WMRE Institutional Investor Survey (brought to you by Yardi) was conducted via an online survey distributed to WMRE readers in August 2022. The survey results are based on responses from 194 participants. Survey respondents represent a cross-section of real estate industry participants, including 29 percent who identified as an HNW family office investor or advisor, 21 percent as a private REIT or private real estate investor and 20 percent affiliated with a pension fund, institutional investor or life insurance company. More than half (53 percent) described their role as an owner/partner/president/chairman/CEO or CFO-level executive. Respondents operate in all regions with 58 percent active in the East, 52 percent in the South / Southeast / Southwest, 42 percent in the West / Mountain / Pacific and 35 percent in the Midwest / East North Central / West North Central. Respondents are active across property segments, and most are involved in multifamily at 61 percent, office at 41 percent, industrial at 39 percent and retail at 36 percent.*

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