Taking a Timeout

Institutional investors are holding commercial real estate target allocations flat, according to exclusive WMRE research.

By **Beth Mattson-Teig**

Institutions that have been steadily raising commercial real estate (CRE) target allocations higher in recent years are now opting to stand pat as they focus on rebalancing portfolios and wait for pricing to reset in the higher rate environment.

Results from the 2023 *WMRE* Institutional Investor Survey (brought to you by AppFolio) reveal that a majority of respondents (59%) see institutional investor allocations to CRE that are now flat, while 23% report an increase and 18% said that allocations have declined. That is a significant shift compared to the 2022 survey, where nearly half of respondents (48%) reported rising allocations. (The methodology for the 2022 survey was slightly different, but the shift is notable nonetheless). The typical respondent reports an estimated mean 13% average real estate allocation for institutional investors.

A big reason that institutions are taking a step back from higher allocations is likely because many are either at or above their current targets. Strong real estate portfolio returns in 2022, combined with the denominator effect, are contributing to an overallocation in institutional portfolios. According to the *Institutional Real Estate Allocations Monitor*, nearly one-third of institutions surveyed (32.0%) said they were above their target allocations in 2022 compared to 8.7% that responded that way in 2021. The report is published by Hodes Weill & Associates and Cornell's Baker Program in Real Estate.

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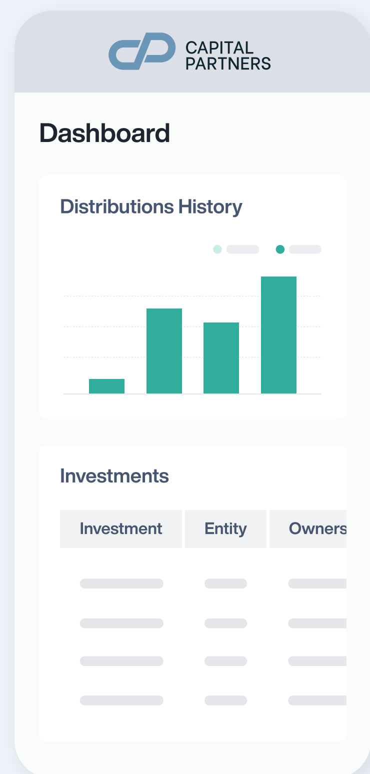

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"That result has followed a steady climb for 10 years in target allocations and is really the first time we have seen actual allocations exceed target allocations," says Doug Weill, founder and co-managing partner of Hodes Weill & Associates, a global capital advisory firm. That shift has occurred for obvious reasons, including the performance of public equities and fixed income, and other asset alternatives that performed poorly in 2022. In fact, 2022 was the first time since the 1930s that both fixed income and public equities had a negative return in the same calendar year, notes Weill. "That really whipsawed institutional portfolios and put institutions largely at or over-allocated relative to their target allocations, and that has resulted in a real dramatic slowdown in allocations to funds and transactions," he says.

It is important to note that the overallocation due to the denominator effect has been remedying itself over the last two quarters as real estate valuations have declined and equities and bonds have rebounded to some degree, notes Todd Henderson, co-global head of real estate at DWS, a global asset management firm. In addition, institutions are taking advantage of opportunities to generate liquidity within their real estate portfolios to help rebalance allocations. However, institutions are not leaving the asset class. They still like the benefits real estate offers in terms of income, diversification and a hedge against inflation, he says.

Henderson has also seen some institutions that are increasing their targets to real estate. Investors in that boat like the inflation benefits associated with real estate, and they also believe the asset class, outside of office, will perform well both during and following the current choppiness of the economy. "Most institutions are beginning to get ramped up for making allocations in second half of this year or first half of next year," he adds.

Headwinds to higher allocations

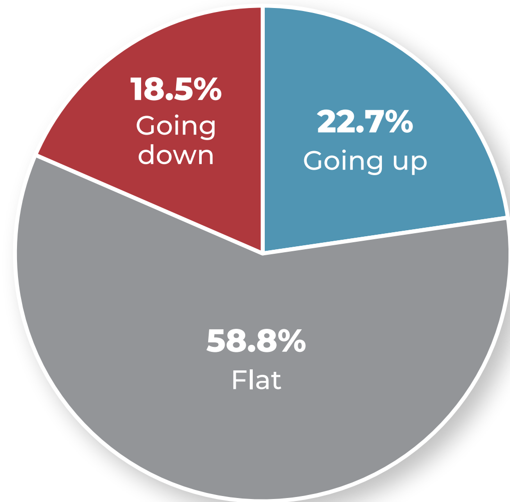
Rising interest rates remain a top concern for institutions. Overall, 61% of respondents believe that rising interest rates are likely to have the greatest negative impact on institutional investors' allocations to real estate. Despite continued talk of a potential recession, fewer respondents are concerned about a recession or real estate downturn negatively impacting allocations to real estate at 38% and 34%, respectively.

"What we're hearing from our institutional clients is that they're going to stay the course and keep current allocations, which is somewhat predictable, given that interest rates have been increasing pretty rapidly," says Mike Sebastian, industry principal and director of investment management, at AppFolio Inc., a firm that provides software, services, and data analytics to the real estate industry. In the higher interest rate environment, it also makes it harder to find deals and predict what returns will be in the future. Institutions, of course, need the return, but they also need the safety. So, it is not surprising that more institutions are holding allocation targets in the current environment, he adds.

According to survey respondents, the two biggest hurdle institutions face in meeting their real estate investing goals is the lack of quality deals (54%), followed by the time required to source/manage deals (40%).

Status Quo

A majortiy of respondents said institutional investor allocations to CRE are flat.



Another big hurdle for institutions in deploying capital in the current market is uncertainty around a myriad of issues, such as asset pricing, impacts from a slowing economy, migration shifts and changes in consumer behavior that are creating new headwinds and tailwinds for different property sectors. "When there is uncertainty for institutional investors, most of them prefer to wait until they see some level of stabilization and some ability to predict the future," says Craig Spencer, CEO of the Arden Group, a commercial real estate fund manager and operator. "The more certainty we get about the future and interest rates, you're going to see activity pick up fairly quickly because there's an awful lot of capital available to invest in real estate," he says. That capital wants to invest in real estate, it is just waiting for the right time, he adds.

Real estate isn't the only asset class that is sensitive to interest rates. Other assets, including equities, fixed-income investments and other alternatives all trade based on the cost of capital, adds Henderson. "So, interest rate movement or volatility doesn't cause permanent or longer-term shifts away from the real estate asset class," he says. Most institutional investors are sophisticated enough to know that a diversified portfolio that includes real estate is the right way to invest. That being said, there is real dispersion in terms of performance across the different property sectors that is impacting where institutions are allocating their capital. And investor expectations regarding returns have also increased along with higher intertest rates, he adds.

Investors prioritize total return

The most important factors for institutional investors when investing in commercial real estate are consistent with previous survey results. On a scale of 1 to 5, total returns rated as the most important factor with a mean score of 4.0, followed by asset value growth, portfolio diversification and income returns—each of which rated a 3.7. Real estate as a hedge against inflation rated a 3.5 and tax advantages trailed at 3.4.

Specific to return expectations, when asked if institutions are more focused on current or overall deal return, most respondents (38%) said they were equally important to investors, while 37% believe they are more focused on the overall deal return, and 25% think they are more focused on current return. A common theme in the current market is that opportunities to generate attractive current returns are driving higher allocations to credit strategies within real estate portfolios.

The overall deal return is the main focus among institutions that Mill Creek Residential is having conversations with. "We're in a strange market right now with the inverted yield curve and the cost of debt today that is so different than what it was in early 2022," says David Reynolds, president of investment management at Mill Creek Residential, a developer, owner-operator and investment manager specializing in rental residential properties. The cost of debt on an acquisition is going to be on average about 5.5% and the purchase price is around 4.75% for an unlevered return. "So, you have this weird situation where if you are doing acquisitions, you have to buy into the fact that you're going to be able to grow those returns largely, and also there is some anticipation that interest rates are going to return to a normal yield curve and that interest rates at some point will be lower," he says.

Multifamily, industrial remain top choices

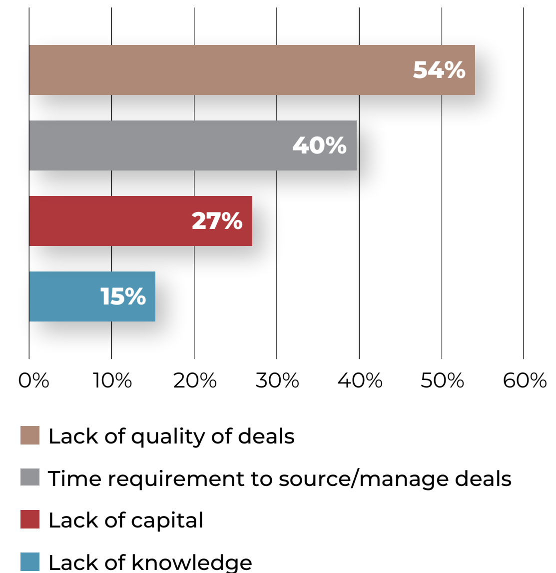
Survey results show that multifamily and industrial remain the favored property types. Respondents said institutions are most likely to prefer investing in multifamily (60%) and industrial (50%), followed by life sciences/biotech (43%), medical office (38%) and self storage (38%). Those sectors that were viewed least favorably included retail (19%), hotel (18%) and office (17%).

Multifamily remains firmly entrenched as the most popular sector for a variety of reasons. Multifamily has historically been number one or number two in terms of generating the highest returns. So, it's that historical performance, the ability to mark leases to market rents every year and the overall shortage of homes that continues to drive demand for multifamily, notes Reynolds. "We expect the residential rental sector to perform well in the coming years because of the shortage of homes and because of the decreasing affordability of homeownership," he says.

Multifamily has also become a more nuanced strategy. Institutions are taking a more granular approach to residential strategies that dig into price point, location and property type across core, value add and new development, says Reynolds. "We're especially seeing more of an interest in what we call attainable or more affordable multifamily product," says Reynolds. In addition, institutions are expanding their residential strategies to include more niche sectors, such as single-family rentals, student housing and seniors housing. Last year, Mill Creek Residential raised $1.2 billion in equity across multifamily development, build-to-rent single family and value-add acquisitions. "We're seeing interest in all of those areas, and investors are viewing it as an attractive time to get into the market," he says.

Obstacles to Overcome

Respondents were asked to identify the biggest hurdles institutions face in meeting real estate investment goals.



It is no surprise that sentiment on office continues to slide. "Most investors have dialed down their focus on office for some time," says Weill. Over the past five to 10 years, institutions have come to realize that office is a very capital-intensive strategy due to the cost of re-tenanting buildings and renovating space, which really cuts into profit margins. Institutions have reweighted their portfolios towards multifamily, industrial, self storage, data centers and other kinds of niche strategies, and those strategies continue to have very favorable operating fundamentals and tailwinds that are driving the positive returns that we continue to see in the market, he says.

Unfortunately, there is a bit of a herd mentality in real estate, adds Spencer. "Right now office is the asset class you don't want to touch. Lenders don't even want to hear about it, and that's a bit nonsensical," says Spencer. According to Spencer, trophy office assets in most of the top markets have either been matching or outperforming compared to

pre-pandemic levels, because of the flight to quality. "If you're looking at very high quality office buildings in dynamic markets [they] are having record occupancy and record rents. You can't paint that with the same brush as a B quality office building in a poor location that is losing tenants every other month," he says. However, there is a clear shift in strategy that is affecting allocations within real estate portfolios. Many institutions are reducing their exposure to office, while increasing allocations to industrial, multifamily and other alternative sectors, he adds.

Real assets strategies focus on infrastructure

When asked what other real assets institutions are targeting, infrastructure was the most popular choice at 54%, followed by natural resources at 44% and/or agriculture/farms at 42%. Timber trailed more distantly at 22%.

Interest in infrastructure is likely getting a boost from two key pieces of legislation, the Bipartisan Infrastructure Law and the Inflation Reduction Act, that will create significant new funding for a variety of new infrastructure projects ranging from traditional roads and bridges to renewable energy. Natural resources and infrastructure related to green or transitional energy are also gaining more attention because of the increased focus on ESG. "A lot of institutions have a big ESG push. So, you can see how some of these real assets would fit into their environmental strategy," says Sebastian. AppFolio has also seen more of its clients express interest in farms and timber, which tend to have long-term hold periods.

Outside of real estate, the other two most popular alternative asset classes are infrastructure and private credit. One reason behind that interest is the size of the investible universe. Both infrastructure and private are significantly larger than timber and farm. Private credit is also a diversification away from more volatile equity returns when most of the private credit return will come in the form of income, notes Henderson.

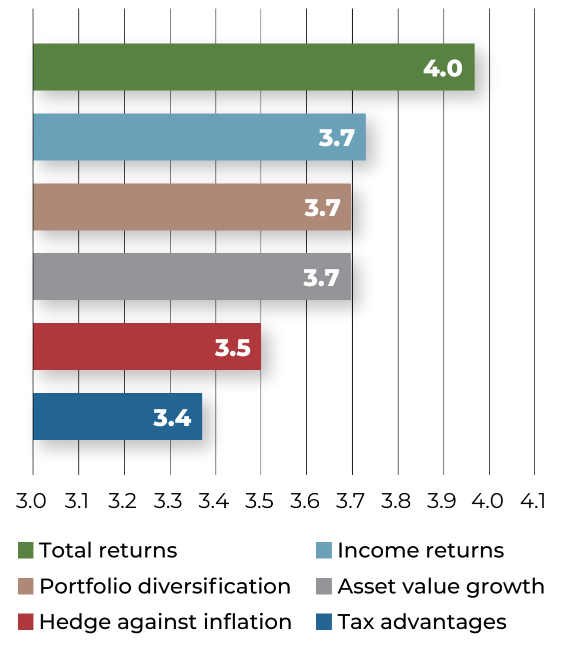
Capital tilts towards direct deals

Respondents believe institutional investors are most interested in direct investment in multitenant commercial and multifamily real estate assets. On a scale of 1 to 5, direct investment in multitenant properties rated a 3.2, followed closely by private equity real estate funds and private debt funds, each at 3.1. Despite the recent performance of public REITs, the asset type scored relatively favorably at 3.0. Sentiment on non-traded REITs and CMBS were the least favorable at 2.6 and 2.5, respectively.

"I do think the trend towards direct vehicles is real and the largest institutions are trying to both control their destiny and have decision-making rights, but also lower the cost of portfolio management by bringing some of their portfolio investments in-house," says Weill. That being said, almost all institutions are looking at commingled closed and open-ended funds as a way to deploy capital, he says. According to the *Allocations Monitor*, approximately 90% of institutions expect to allocate future investments to third-party managers.

Returns Trump All

Total returns topped the list of most important factors for institutional investors when investing in commercial real estate.

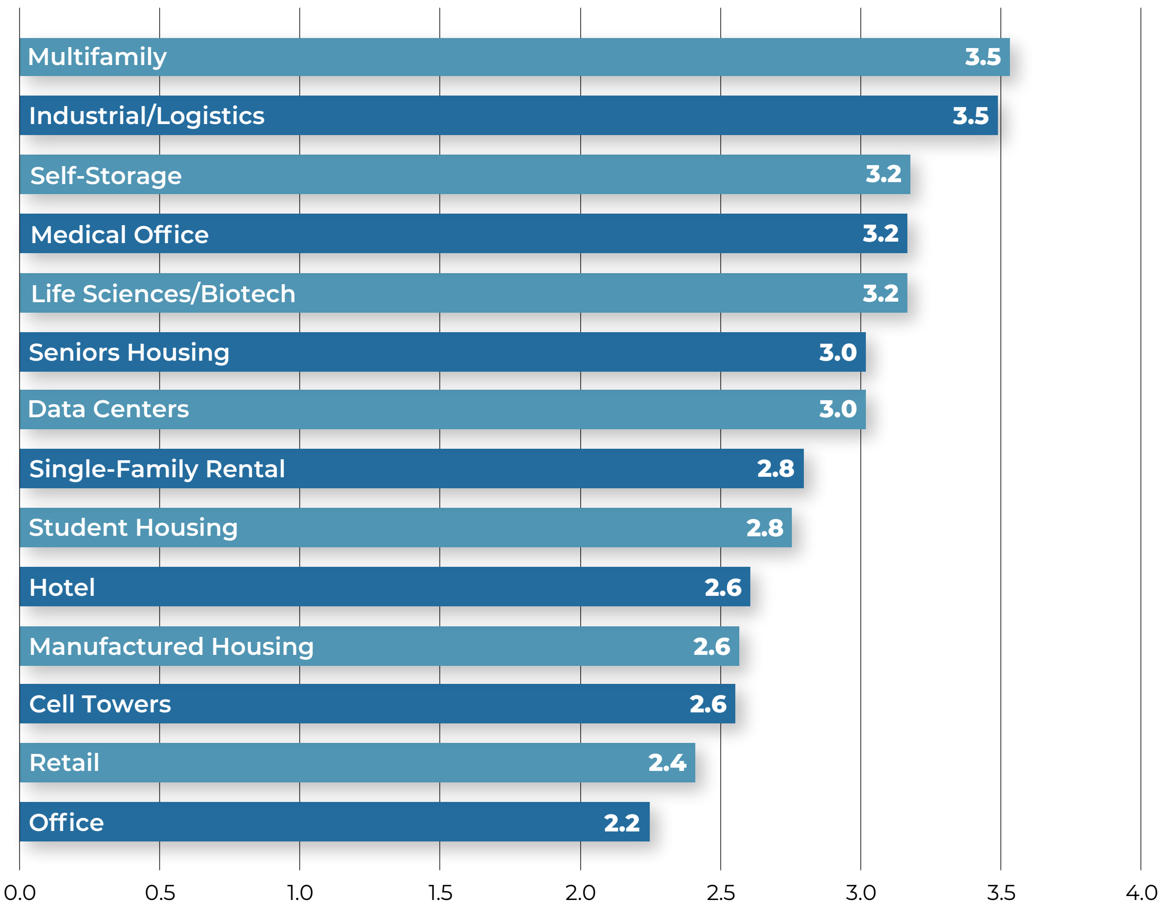


The interest in direct deals likely also includes joint venture structures. "We're seeing a lot of institutions going into joint ventures," notes Sebastian. Some institutions like having more control and more recourse compared to going into a fund or other structure, and they also get a lot more insight into the asset-level data on those deals. Although institutions may bring the majority of the capital, they are going into deals with a partner that has specific expertise to manage the deal, he adds.

Steady focus on primary markets

The pandemic and shifting migration patterns do not appear to be much of a deterrent for investment in primary markets. On a scale from 1 to 5, primary markets rated a mean score of 3.6, while secondary markets scored a 3.0 and tertiary markets a 2.3.

"I think it largely depends on the sector. For office, institutions are hard pressed to find a reason to invest in San Francisco, whereas historically it was very much an institutional market," says Weill. Some other global gateway cities, such as New York, London and Paris, continue to maintain good valuations on core, high-grade assets, he adds. Beyond that, most investors are focused more on following the jobs



and investing in growth markets. In the U.S. that has meant more institutional focus on the Sun Belt states, he says.

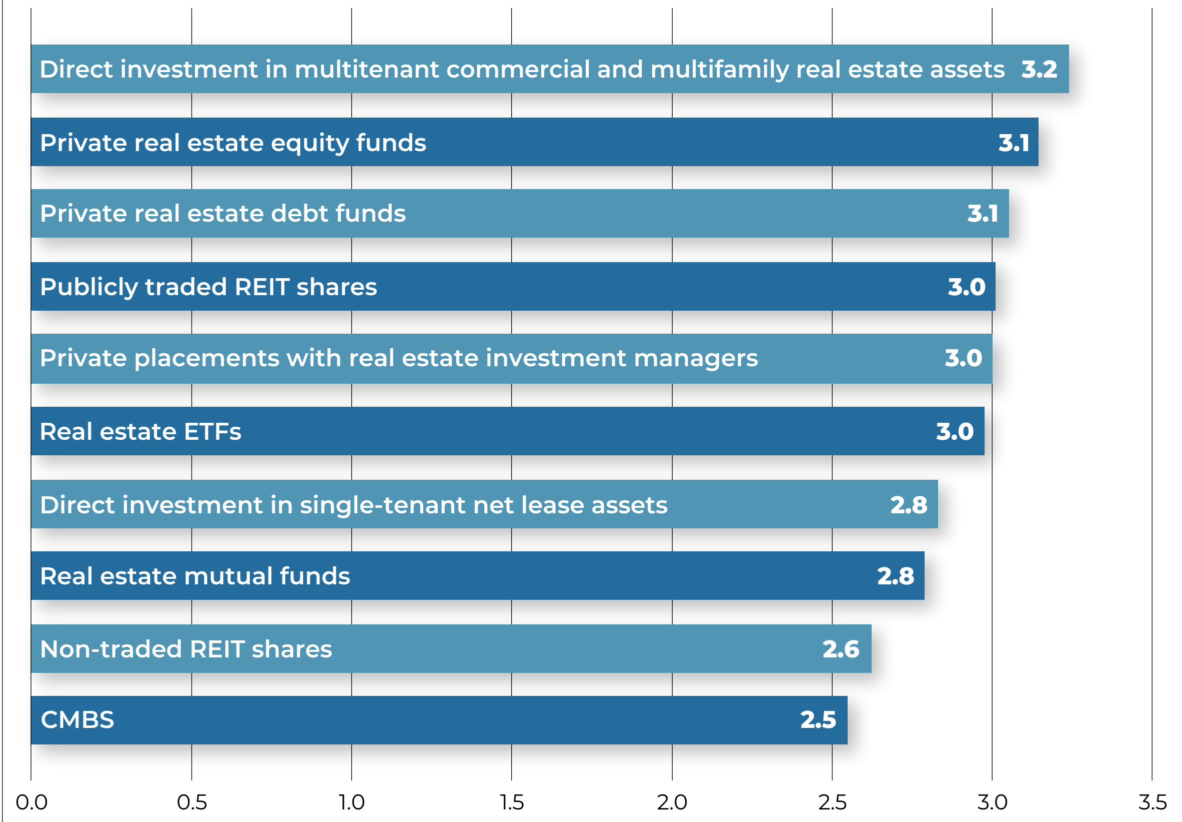
Arguably, the traditional definition of primary markets is more subjective. Some view markets such as Miami and Dallas as moving up into the list of primary markets. Primary markets also vary depending on the specific property sector. For example, the tier one markets for life sciences are Boston-Cambridge, the Bay Area and San Diego.

Specific to its equity fund strategy, the Arden Group is investing in industrial, hospitality and trophy office. Its geographic focus is on major markets and what it calls dynamic secondaries. "We prefer to stay in major markets that we think have long-term positive trends," says Spencer. For example, New York City has a lot of problems, such as a massive office inventory. However, at the end of the day it is still the financial capital of the world and a place people want to be for a lot of different reasons. "So, for the right asset, at the right price, with the right strategy, we would be in New York all day long," he says.

Dynamic secondaries are also attractive due to the population shift into markets such as Charlotte, Raleigh-Durham, Miami, Dallas, Austin, Denver, Salt Lake City and others. In contrast, Arden Group is wary of the risks that exist in secondary and tertiary markets, including cyclical market and economic risk, as well as liquidity risk that could impact an exit strategy, notes Spencer.

Navigating challenges and opportunities ahead

Institutions are navigating cautiously in a market where there are still plenty of hurdles. Uncertainty, finding deals and rebalancing of portfolios were cited as some of the common challenges in working with institutional investors in the current market. "Frozen transactions markets with little price discovery are frustrating, and it's hard to find liquidity at scale," wrote one respondent. Another respondent wrote:



"The biggest challenges in dealing with institutional investors looking to invest in real estate include meeting high expectations for returns, fulfilling rigorous due diligence requirements, and navigating complex deal structures."

"The biggest challenge I think any investor faces right now in an inflationary environment with rising interest rates is finding deals that make economic sense compared to the alternatives, such as stock, bonds or derivatives," says Sebastian. At the same time, these institutions also have mandates to be invested in certain asset classes, including real estate, and they like the characteristics of real estate. Institutions look at it as a hedge against inflation, as well as a hedge against the more volatile assets like stocks. That hedge is attractive in a market where there is still talk about an impending recession, he says.

So, while there is a pause in allocations, institutions still have capital to deploy. They are waiting for assets to reprice and waiting for more deals to come to the for-sale market. More institutions are shifting strategies to lending to take advantage of opportunities and demand that exists for financing. They also anticipate some distress in the market, and they are looking at opportunities to invest on both the equity and debt side of those deals. "So, there are all sorts of different ways in the real estate and private equity markets where they are getting involved, or where they are anticipating opportunities that they are getting ready for," adds Sebastian.

Survey methodology: *The WMRE Institutional Investor Survey (brought to you by AppFolio) was conducted via an online survey distributed to WMRE readers in May 2023. The survey results are based on responses from 120 participants that directly work with institutional investors. Survey respondents represent financial advisors (67%) and CRE professionals (33%). Real estate industry participants included a cross-section working in different areas. The biggest group, 22%, identified as leasing or investment sales brokers. Overall, 41% described their role as an owner/partner/president/chairman/CEO or CFO-level executive. Respondents operate in all regions with 68% in the West / Mountain / Pacific, 57% in the South / Southeast / Southwest, 41% active in the East and 30% in the Midwest / East North Central / West North Central. Respondents are active across property segments, and most are involved in retail at 78%, industrial at 65% and multifamily and office each at 59%.*