Tapping the Brakes

With the sector facing headwinds, HNWI enthusiasm for commercial real estate has dampened according to WMRE exclusive research.

By **Beth Mattson-Teig**

High net worth individual (HNWI) investors that have been steadily increasing allocations to commercial real estate over the past several years appear to be taking a pause amid market uncertainty. That's according to the latest edition of research surveying readers of *WMRE* and WealthManagement.com (brought to you by Ashcroft Capital).

The annual survey polls both financial advisors and commercial real estate professionals to get their perspectives on HNWI and accredited investor strategies related to commercial real estate investing. The survey also sheds light on where perception of HNWI investment aligns or diverges between the real estate and wealth advisor communities and on how sentiment shifts from year to year.

One area where both camps agree is that 61% report that HNW allocations to commercial real estate are flat. Those results are dramatically different from a year ago when nearly half of financial planners and three-fourths of commercial real estate professionals reported rising allocations to real estate. This year 34% of real estate pros and 26% of advisors said allocations to the sector are rising.

"Coming out of the Great Financial Crisis, the trend has been increasing allocations to commercial real estate. That hasn't been just a linear trend, but moving in an upward direction for a decade," says Jay Frank, president and COO of Cantor Fitzgerald Asset Management. That being said, new commitments to commercial real estate began to slow in late summer 2022. The slowdown accelerated into year-end and has continued into the second quarter due to market uncertainty and the impact of higher interest rates on real estate values. With the latest 25 basis point rate increase on May 3, the Fed has now raised interest rates at 10 consecutive meetings for a total of 500 basis points since early March. Once the Fed signals that it is going to be done with its rate increases, it will likely lead to investors picking their pencils back up and getting back in the game, adds Frank.

A second reason behind the pause in new allocations is that investors are rebalancing portfolios following a drop in stock values. "We're seeing the target allocations to real estate stay generally the same, but due to the denominator effect, the actual allocation has increased. So, we have seen across the industry less dollars available for real estate because of that," says Zack Otte, a principal and lead of the asset management practice for Plante Moran Real Estate Investment Advisors.

Growing desire for direct investment

Another notable shift in sentiment is that direct investment in multi-tenant commercial and multifamily properties ranked as the most popular investment vehicle. Nearly half of commercial real estate professionals (48%) said that direct investment was the most popular choice for HNWI investors, while 39% of financial advisors picked it. Preference for private equity real estate funds, which has typically ranked number one as the preferred vehicle, dropped to 37% for both camps compared to past surveys where the vehicle consistently rated between 50% to 55%.

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Divergent Views

Real estate pros believe HNWIs have a strong preference for private real estate while financial advisors see the preference for public and private options split more evenly.

	Financial Advisor	CRE Professional
Direct investment in multitenant commercial and multifamily real estate assets	39%	48%
Private real estate equity funds	37%	37%
Private placements with real estate investment managers	31%	31%
Direct investment in single-tenant net lease assets	26%	35%
Real estate ETFs	37%	9%
Publicly traded REIT shares	34%	11%
Real estate mutual funds	32%	11%
Private real estate debt funds	18%	16%
Non-traded REIT shares	15%	7%
Club deals	7%	15%
Real estate BDCs	12%	1%
DST placements	7%	9%
CRE crowdfunding	7%	8%
Real estate interval funds	8%	2%
Other	3%	5%

there does appear to be a preference for direct investment," says Mehul Chavada, CIO at Casoro Group, a commercial real estate investment firm serving HNWI clients. That focus is likely being driven by a desire for greater control in this uncertain market. Over the past few years, competition fueled compressed cap rates, which made it very easy for everyone to make money, notes Chavada. "We're no longer in those times where you're making money just because you bought an asset. Now you have to hold it for longer and generate cash flow and that alpha," he says.

Private placements also rated favorably among 31% of respondents, including an equal number of both financial advisors and commercial real estate professionals. Ashcroft Capital is one firm that has seen interest in private placement funds become more popular since 2020 compared to individual asset offerings. "A lot of that had to do with the pandemic and investors that were sitting on the sidelines or seeking ways to diversify and limit risk, as we see in any type of recession or pullback," says Travis Watts, director of investor education at Ashcroft Capital, a real estate investment firm specializing in value-add multifamily properties.

However, there is a divergence between advisors and real estate pros when it comes to identifying vehicles. Real estate pros tend to identify private real estate structures (funds, placements, direct investment) as the top choices, while advisors have a more balanced view and rate REITs, ETFs and mutual funds as more popular options.

Advisors rated ETFs (37%), REITs (34%) and mutual funds (32%) nearly as highly as private options. However, those figures are all drops from 2022 for ETFs (49%), REITs (43%) and mutual funds (35%). Real estate pros, however, scored REITs and mutual funds at 11% and ETFs at just 9%. Wealth advisors also had higher scores than real estate pros for semi-liquid structures, with non-traded REITs (15% vs. 7%), BDCs (12% vs. 1%) and interval funds (8% to 2%). Notably, the sentiment on ETFs, REITs and mutual funds did drop for both camps from a year ago.

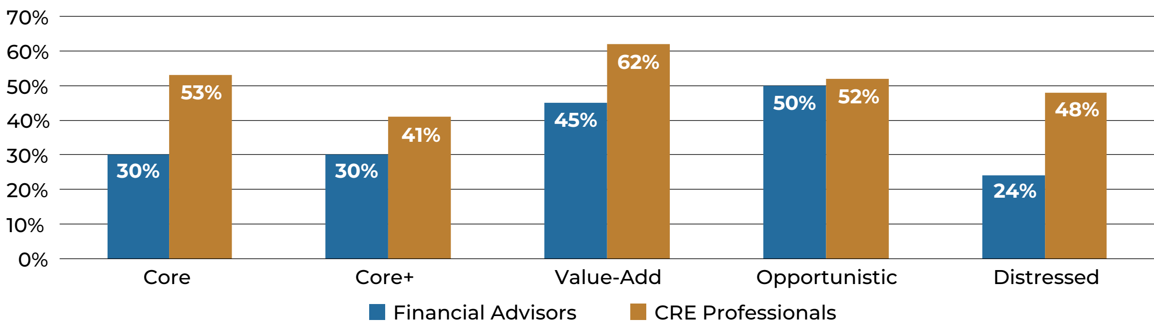
"No matter the vehicle, we're definitely seeing a shift towards high-quality managers that have a track record of navigating through prior cycles, so you have more of that comfort in having that experienced management team to be able to navigate through this current cycle," says Otte. However, for those clients who are doing direct investing, Plante Moran is seeing investors take more of a "pencils down" approach as they wait for signals from the Fed that its rate increases are going to be paused, he adds.

HNWIs wary of downside risks

Given the current backdrop of market volatility and uncertainty, downside risk is top of mind for investors. When asked what events are likely to have the greatest negative impact on accredited investors' allocations to real estate, the increase in interest rates poses the biggest threat, although more financial advisors see that as a bigger concern at 58% compared to commercial real estate professionals at 49%. Views between the two groups were more aligned on other top events, including a

Appetite for Risk

Real estate professionals said HNWIs have a strong preference for Core or Core+ real estate while financial advisors gave value-add and opportunistic higher marks.



real estate downturn at 41% and a prolonged recession at 37%.

"Interest rates right now are one of the biggest issues on the minds for everyone, along with recession. Those are two things that fundamentally impact real estate as an asset class," says Chavada. Broadly, the market is anticipating a repricing of assets due to higher capital costs. Over the last 15 years, there has been a mentality where a high tide rises all boats. But you can no longer buy something and make money simply by way of cap rate compression. And because of high interest rates, investors have to be careful with negative leverage, such as buying a property at a 5% cap rate when borrowing rates are at 6%, he says. A recession could also significantly impact rent growth, which HNW investors really rely on to generate income, adds Chavada.

Another area of friction is in how real estate pros and wealth advisors viewed HNW preference for risk. Real estate pros believe HNW investors have a strong preference for core or core-plus investments, while wealth advisors scored value-add and opportunistic higher.

For example, on core, 53% of real estate respondents said HNW investors were "extremely" or "very" interested vs. just 30% of wealth advisors. For core-plus the scores were 41% to 30%, on value-add 62% to 45%, opportunistic 52% to 50%.

And although there is greater hesitation around distressed investments, a surprisingly high number of respondents (69% of commercial real estate professionals and 57% of financial advisors) said wealthy individuals are at least moderately interested in those investments.

"Value-add, from what I see, is still the most favored among high-net-worth individuals, but the caveat is if you can find a true value-add deal that pencils and cash flows on day one. Deal flow has really slowed compared to the previous two years," says Watts. Core assets are still popular among institutions for their lower risk profile, but the cash flow yield is typically much lower in exchange for that risk profile. While that may not be a big deal for an institution working with billions of dollars, it is often important to HNWIs who are seeking higher cash flow, adds Watts. For example, a 4% return on $1 billion is $40 million, whereas a 4% return on $1 million dollars is $40,000.

Broadly, there has been a "risk off" mentality that started last summer and accelerated, notes Frank. "This is not an idiosyncratic issue where one sector is getting hit because of one reason. It's been more of a blanket impact due to higher borrowing costs, tighter lending standards and lower investor confidence that are impacting all types of real estate assets, whether it is core, value-add or opportunistic. Of course, this transcends just real estate," he says.

However, with the Fed now signaling a pause and markets betting on lower rates into year-end, this may be the beginning of an attractive entry point into commercial and multifamily real estate following a reset in values, and where existing owners are under stress, leading to the potential to deliver outsized returns for new investors. "Investors with liquidity, operational experience and risk tolerance will be able to identify opportunities ranging from buying core assets at compelling prices from distressed owners to the acquisition and repositioning of distressed properties from foreclosing lenders. There will also be attractive relative values in the commercial real estate debt markets ranging from mezzanine debt to preferred equity and CMBS securities," says Frank.

Multifamily remains top choice

Financial advisors and commercial real estate professionals are in agreement that the top two property types wealthy individuals prefer are multifamily and industrial. However, commercial real estate professionals have stronger conviction in their opinions. A bigger majority of commercial real estate professionals believe accredited investors prefer multifamily (70%) or industrial (64%). Nearly half of the financial advisors surveyed (48%) said that accredited investors prefer multifamily, followed by industrial (36%). Self-storage ranked as the third most attractive property type among 40% of financial advisors and 35% of commercial real estate professionals. But in general, financial advisor responses on property types were more evenly distributed than the perceptions of real estate pros.

Respondents are significantly more pessimistic on the attractiveness of office. In the current survey, only 18% of financial advisors and 9% of commercial real estate professionals said HNW investors had a preference for the sector. It is also notable that sentiment on office has been on a steady downward trend as a result of the challenges the sector has faced during and after the pandemic.

"The fact that multifamily has remained a top pick for investors is really not a surprise, because here in the U.S. we're still over 1 million homes behind in meeting the current consumer demand for affordable places to live, and that has been the case for about 20 years," says Watts. Investors understand that basic supply and demand story for housing, as well as the fundamental reality that everyone needs a place to live. Right now, the U.S. has one of the biggest affordability gaps on record between renting and owning. National rents are hovering around $1,700 per month according to Yardi Matrix, compared to average mortgage costs with rates on a 30-year fixed loan at about 6.5% at about $2,500 per month.

Of the traditional four property types, multifamily and industrial remain favored for their long-term fundamentals, agrees Otte. "We're also seeing some niche asset classes that are now more institutionalized becoming more interesting to investors, such as single-family rentals, manufactured housing, student housing and healthcare," he says. Investors like the diversity that those alternatives provide, while at the same time they recognize the demand for those products, as well as the overall fundamentals and risk-adjusted returns. Student housing, for example, is a sector that tends to be countercyclical, notes Otte.

Consistent with last year's results, HNWIs continue to favor the safety of primary and secondary markets and here the views of both the advisor and real estate professionals audiences aligned. A majority of both segments said HNWs have a moderate, strong or extreme preference for primary markets at 81% and secondary markets at 80%, respectively. They viewed HNW interest in tertiary markets lower at 47%. According to Otte, investors are focused mainly on primary and secondary markets, with the caveat that there is a keen focus on migration trends. Most HNWIs are not looking at tertiary markets, because there is less certainty on the ability to exit.

"Tertiary markets have the added risk of how deep is that market," he says.

Property Type Views

Views on what property types HNWIs prefer also diverged heavily between the advisor and CRE professional camps.

	Financial Advisor	CRE Professional
Multifamily	48%	70%
Industrial/Logistics	36%	64%
Self-Storage	40%	35%
Medical Office	35%	35%
Data Centers	32%	13%
Single-Family Rental	22%	28%
Life Sciences/Biotech	24%	21%
Seniors Housing	28%	14%
Retail	19%	26%
Hotel	22%	17%
Cell Towers	24%	4%
Office	18%	9%
Student Housing	12%	9%
Manufactured Housing	9%	9%
Other	3%	3%

Greater focus on tax advantages

Consistent with past survey results, the biggest investment priority for HNWIs is preservation of wealth, which rated 3.8 out of 5. Meanwhile, commercial real estate investing for tax advantages is now on par with wealth preservation at 3.8, climbing 10 basis points compared to scores of 3.7 in the prior two years of the survey.

HNWI investors have historically used real estate for wealth preservation and building wealth. Although wealth preservation remains a priority, Chavada is seeing more focus on income and tax strategies due to current market conditions. "We're in a very different inflationary environment than what we have been in for the past 40 years," says Chavada. If inflation is going to stay higher for longer in that 4% to 6% range, that really creates the challenge in terms of, how do HNWIs sustain their wealth preservation goals? "That is really driving the need to have more of an income mindset. We're back to where people want to hold assets for longer and really drive cash flows where they can get income returns versus cap rate compressions and the short game," says Chavada. Another reason tax strategies are top of mind for investors is that a lot of deals really don't pencil out unless there are some tax advantages for doing the deal, he adds.

Wealth preservation and tax advantages were followed closely by asset value growth at 3.7 and portfolio diversification, steady income and a hedge against inflation—each of which rated 3.6. Estate planning trailed more distantly at 3.3.

For many HNWI investors, the answer is really "all of the above" as all of those factors weigh heavily in real estate investing strategies. "HNWIs have historically understood the importance of building a diversified investment portfolio that includes not just stocks and bonds, but alternatives like real estate," says Manish Desai, managing director in Brookfield's Real Estate Group and president and chief operating officer of the Brookfield REIT. "A high-quality real estate portfolio that is diversified across property types and regions has the potential to help HNWIs achieve their outcomes, whether that is stable income generation and capital appreciation, an

inflation hedge or overall portfolio diversification."

Survey respondents were fairly aligned in their views of return expectations. Financial advisors estimate that wealthy individuals expect an average return of 10.8% from real estate investments, while commercial real estate professionals see a slightly higher average of 11.3%.

"Return and risk expectations vary by type of strategy. Given the increase in the cost of capital, overall return expectations have returned to historical averages from compressed levels in recent years," says Desai. "That said, we still believe returns in the high teens are achievable for experienced real estate investors in opportunistic and value-add strategies, while core, income-focused strategies can target high single digit/low double-digit returns." In addition, operational expertise and experience investing through multiple real estate cycles will be paramount to generating returns going forward, he adds.

HNWI sector offers opportunities & challenges

On a positive note, the overall size of the HNW market and wealth held by this group is continuing to grow. According to the 2022 Capgemini World Wealth Report, the global HNWI population grew by 7.8% and their wealth grew 8% in 2021. North America saw the highest increase in HNWI population and wealth at 13.2% and 13.8%, respectively. Capgemini credits that growth largely due to the post-pandemic recovery.

The Capgemini report also shows that HNWI allocations to real estate have held steady at 15% over the past three years. *WMRE* survey respondents have different views on HNW allocations to commercial real estate, with financial advisors on the lower end at 10.9%, compared to commercial real estate professionals that estimate the average to be higher, at 20.1%. However, both groups agree that individual portfolio allocations vary widely from those that have no capital in real estate to individuals who have concentrations in the asset class upwards of 40%. In addition, a majority of financial advisor respondents (72%) said that they have clients who have invested in real estate and another 13% said clients are interested in real estate but have not yet invested.

One of the most notable trends over the past few years is that HNW investors who did not have any allocation to commercial real estate have started to invest in the sector, notes Frank. That shift has a lot to do with the success of some very large players that have successfully raised billions of dollars across different private real estate strategies. Aside from recent redemption requests, Blackstone has exhibited tremendous power in raising tens of billions of dollars in the non-traded REIT space in recent years. "As the industry has addressed some of the barriers to real estate investment, such as liquidity, allocations to commercial real estate have increased and more people that traditionally didn't have exposure to private real estate are now adding a significant allocation," says Frank.

In the past, one of the biggest challenges for HNW investors looking to invest in real estate was access. "Given the democratization of private real estate and enhanced investability, access to institutional quality alternatives platforms is improving," says Desai. "But with greater access comes the responsibility of real estate investors to educate their clients on the role that the asset plays in a diversified portfolio. Many HNWI understand that allocating to real estate is a strategic, long-term decision. But those newer to the asset class should seek an experienced, trusted partner who can offer the right real estate solutions to meet stated investment goals." ■

Place in the Portfolio

On balance, CRE pros estimated HNWIs had 20% allocations to real estate while advisors pegged the level at closer to 10%.

	Financial Advisor	CRE Professional
Less than 2%	15%	5%
2% to 5%	19%	6%
6% to 10%	24%	13%
11% to 15%	19%	17%
16% to 20%	8%	18%
21% to 25%	7%	8%
26% to 30%	2%	10%
31% to 35%	2%	5%
36% or more	4%	19%
Mean	10.9%	20.1%

Survey methodology: *The WMRE High-Net-Worth Investor Survey (brought to you by Ashcroft Capital) was conducted via an online survey distributed to Wealthmanagement.com and WMRE readers in April 2023. The survey results are based on responses from 295 participants. Of the total survey respondents, 65% identified themselves as financial advisors and 35% as commercial real estate professionals. More than half of the respondent base work for an independent B/D or RIA. Among commercial real estate professional respondents, 61% said they were an owner, partner or C-suite executive. Respondents operate in all regions with 46% active in the South / Southeast / Southwest; 41% in West / Mountain / Pacific; 37% active in the East and 24% in the Midwest. In addition, respondents are active across property segments. Most are involved in the four main sectors, with multifamily at 56%, retail at 50%, office at 46% and industrial at 45%.*

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