Ares Management Corporation

Rising need for liquidity solutions in an uncertain market environment

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Michelle Creed** and **Jamie Sunday,** both partners and co-heads of real estate secondaries, with Ares Management Corp. Following is an excerpt of that conversation.

How active is the secondary market in the current environment?

Michelle Creed: The market is extremely active, and the cadence of new transactions has been picking up steadily during the past couple of quarters. Some of these conversations were building in late 2022 and into early 2023. They are finally coming to a head, however, and becoming actionable as year-end 2022 and first-quarter 2023 net asset values track down, making discounts more palatable.

Jamie Sunday: We expect another record year for secondary market transaction volume in 2023. An increasing number of fund sponsors are currently trying to manage through a lot of different issues, such as creating liquidity for investors, managing through near-term debt maturities, getting a term extension to finish business plans, etc. All these ingredients are super-charging our market right now and creating a significant number of opportunities. In addition, there has been a pronounced uptick in the number of investors bringing fund portfolios to market in order to free up capacity, rebalance, etc.

As you alluded to, last year was a record year, with $12.4 billion of volume. Do you have an estimate for this year?

Sunday: It is hard to give a specific projection at this point. We track all secondary opportunities that come across our desk. Secondary transaction volumes tend to be more heavily back ended in the year. Based on what we are seeing come to market now, we would anticipate a very active second half of the year. Looking forward, there are a couple key elements that will affect the trajectory of the market over the next few years. The first is the amount of net asset value held across closed-end real estate funds, as that is a significant component of the overall opportunity set in the secondary market. This has grown to more than $900 billion, and there is an additional $500 billion of uncalled capital, as of June 30, 2023, that will add to the NAV base as it gets invested. A second element is the growth and evolution of the fund sponsor–led transactions. In private equity, these transactions have been part of the fabric for a much longer period. Fund sponsors lean into these transactions as one of the main sources for driving liquidity to their fund vehicles. In real estate, it is still a new concept, but it is gaining traction. Given these elements, we would be very surprised if transaction volume doesn't double during the next three to five years and reach north of $20 billion.

What were the fundamental reasons why the fund sponsor–led secondaries started to take off?

Creed: There was recognition by the fund sponsor community that what private equity sponsors were doing made sense for real estate, as well. In addition, there have always been recapitalizations within the real estate space — many of these are now categorized as secondary transactions. Going into the pandemic, fund sponsors had the opportunity to look at their portfolios and recognize how they could either pivot, strategically grow or have some sort of transformational change within their business. All those reasons started to pique fund sponsor curiosity. Today, the motivation is a little bit different, and I would say it is less opportunistic and more need driven.

Sunday: Fund sponsor–led transactions is a broad term, as there are varying types that accompany varying types of objectives fund sponsors are looking to accomplish. For example, during the pandemic, industrial as well as single-family rental [SFR] performed extremely well. Fund sponsors that may have owned an industrial or SFR portfolio within their value-added fund may want to realize the IRR for their fund while continuing to control the portfolios if there were still a runway for rental growth and value creation. Spinning assets or portfolios out of funds into continuation vehicles is becoming more common in real estate. Therefore, some of the best portfolios may never hit the market because they will continue to be owned by the same sponsors that aggregated the portfolios. Another type of sponsor-led transaction is a fund recapitalization, where the objective is to provide a liquidity option for investors while extending the term of the fund sufficiently to finish business plans.

What are some of the pressures facing fund sponsors today?

Creed: As of today, there are two main issues. One is the race against time. When fund sponsors recognize the assets in their fund are not going to meet their original goals because of the overall capital markets slowdown, continuation vehicles are an option to provide relief. They might hold good assets, and maybe there is no reason to have a fire-sale. But there are investors who want liquidity, so a continuation vehicle is a way to help solve for that scenario. The second issue, also tied to capital markets, relates to when a fund sponsor recognizes they need to recapitalize an asset or a subset of assets to help right-size the leverage within their current vehicle. Those are some of the types of opportunities we are seeing that are more need-based. Others are recognizing the only way to get their existing investors to commit to their next fund is to return capital to those same investors. We have seen transactions by both U.S. and European managers seeking capital relief in the form of distributions for their investors. Most investors are astute in recognizing that value-added and opportunistic funds are likely to do best during times of distress. If you broadly label 2023–2024 vintages as a time of stress or dislocation, investors are going to miss out on these opportunities if they don't have commitments available. At the same time, their boards are saying they cannot increase their real estate allocation in the current environment.

Sunday: For a good number of maturing funds, there is a genuine need, given COVID-19 and the pause of business plans, to provide another few years of term to finish business plans and maximize value. Fund sponsors want an efficient extension of the fund term, while being mindful to provide investors with a viable liquidity option. In these circumstances, secondary groups will price the fund, the fund sponsor acts as facilitator, and ultimately each investor makes the decision to either sell or stay in the fund. If investors are staying in the fund, they are typically agreeing to extend the fund by some period of time. Ares has closed multiple fund recapitalizations and anticipates seeing several other funds getting recapitalized during the next 12 months to 24 months. Of the $900 billion of NAV that is outstanding, more than $230 billion of that is in closed-end funds that are more than eight years old. That is a significant amount of value held in funds that are maturing.

What are average pricing discounts on investor portfolios? What do you think is driving that level of discount? Is there a bid-ask spread?

Sunday: Pricing discounts are highly varied today based on property sector, vintage and the NAV date. NAVs across the industry are inflated. They have not been fully adjusted to today's interest rates and cap rates in the direct market. Overall, "optical" pricing discounts are high. Most funds we have recently priced in the secondary market have discounts ranging from 25 percent to 50 percent or even greater. Funds with a heavy office exposure, especially U.S. office, could be priced at pennies on the dollar. Discounts on completed transactions averaged around 30 percent in 2022, up from 20 percent discounts the prior year. We will start to see "optical" pricing discounts improve some as NAVs get adjusted to today's reality. It could take multiple quarters, however, before there is meaningful movement in fund values.

What types of transactions and property sectors is Ares Real Estate Secondaries strategy focused on currently?

Sunday: We have had a strong focus in the past two years on industrial, student housing and residential rental real estate debt. We believe we have been able to access these sectors at attractive discounts to intrinsic value and at higher going-in yields when compared with direct market transactions. As a liquidity solution provider, we remain opportunistic and continue to be active in the United States, Western Europe and Asia. We are also pursing an increasing number of preferred equity and other structured capital solutions where our capital is in a more protected or overcollateralized position.

Why is now a good time for secondary market transactions? And what opportunities and risks do you see ahead?

Creed: At $900 billion, with $230 billion in funds that are near expiration, supply has never been bigger in our market. On the other side of the scale is the growing demand created by investors needing liquidity. The economic environment is still uncertain, which increases the motivation to sell. Those two factors combined make it one of the most compelling times to look at the real estate secondary market. Volume numbers will continue to rise during the next several years primarily because of those two factors. Opportunities include continuation vehicles to recapitalizations to debt solutions on the fund sponsor side, to investors trying to free up capital for new strategies. Those elements are going to create opportunities for secondaries managers to access real estate at a different point relative to the direct market and do so at an attractive price. As for the risks, investors certainly need to understand the capital stack they are entering. Long term, fixed-rate debt is valuable today. On the contrary, interest-rate risk needs to be underwritten carefully in the current environment.

Sunday: The secondary market has grown significantly since the great financial crisis, but there is still only a limited number of experienced, well-capitalized buyers. The growth of fund sponsor–led transactions has been exciting and has expanded the overall opportunity set. On top of this, the rapid increase in interest rates, the mounting debt maturities and lingering hangover effects of the pandemic are creating volatility and uncertainty. This is an added catalyst for secondary market activity. Overall, we believe the current environment is shaping up to be one of the most compelling investing environments we have seen since the GFC.

CONTRIBUTORS

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Michelle Creed is a partner and co-head of real estate secondaries in the Ares Secondaries Group. She serves as a member of the Ares Secondaries Group's Real Estate Investment Committee, the Ares Secondaries Group's Infrastructure Investment Committee, and the Ares Diversity, Equity and Inclusion Council. She additionally serves on the Executive Committee of the Ares Secondaries Group.

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COMPANY OVERVIEW

Ares Management Corp. is a leading global alternative investment manager offering clients complementary primary and secondary investment solutions across the credit, private equity, real estate and infrastructure asset classes. Ares seeks to provide flexible capital to support businesses and create value for its stakeholders and within its communities. By collaborating across its investment groups, Ares aims to generate consistent and attractive investment returns throughout market cycles. As of June 30, 2023, Ares Management Corp.'s global platform had approximately $378 billion of assets under management with more than 2,600 employees operating across North America, Europe, Asia Pacific and the Middle East.

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