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Funds rethink pulling plug on real estate

Some institutional investors head for exits, but others start adding to allocations

By Arleen Jacobius
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Looking:: William Maher said investors will not abandon real estate and instead will seek the best opportunities.

Nervous about commercial real estate's plunging valuations, some institutional investors are reducing their real estate exposure but others are putting money in.

Close to 17% — or about $18 billion — of open-end real estate fund dollars is heading for the doors, according to a survey by consultant Wurts & Associates, Seattle, while Buchanan Street Partners, Los Angeles, a real estate investment firm, calculates there is $12 billion now in redemption queues**. Still, "it's not time to be running for the exits," said Eric Petroff, director of research at Wurts. "There are a lot of investors in queues, but it's time to hold allocations and invest more (of their) allocations into debt and opportunistic real estate."**

This year, a number of investors are expanding their allocations, committing to everything from core to opportunistic and to real estate debt. Among the bigger commitments:

- The $8.3 billion Maine Public Employees Retirement System, Augusta, doubled its real estate allocation to a 10% target allocation;
- The $30 billion Illinois Teachers' Retirement System, Springfield, hired Heitman to manage a $1.2 billion core real estate separate account; and
- The $32.7 billion Maryland State Retirement and Pension System, Baltimore, committed $600 million to six real estate funds.

Meanwhile, the Oregon Investment Council, which manages the $44.5 billion Oregon Public Employees' Retirement Fund; the New Mexico Educational Retirement Board; the New York State Common Retirement Fund; and the San Bernardino County (Calif.) Employees' Retirement Association each made real estate commitments of $100 million or less.

Fundraising may be at its lowest point in five years, but real estate funds designed to invest in Europe fared best: The majority of the $8.9 billion funds raised in the second quarter is targeted to European real estate, with five funds raising a combined $5.3 billion, according to Preqin, a London-based research firm. The largest was Blackstone, which raised e3.1 billion ($4.3 billion) for Blackstone Real Estate Partners Europe III.

While fundraising is tough, investors are sticking with the asset class, industry insiders say.

"Investors will not abandon real estate based on this downturn," said William Maher, managing director of research and strategy, North America, LaSalle Investment Management, Chicago.

"They will continue to look at the best opportunities. Last year, the most popular style was distressed debt funds."

A few investors entered queues to exit open-end funds because they were afraid valuations would continue to fall and they wanted to get in line to retrieve their money before the portfolios took the biggest hit, Mr. Maher said.

Some investors are reconsidering their decisions to pull out of queues, Mr. Petroff said.

“A lot of our clients had queued up and some of our consultants have managed to convince them to get out of the queue,” Mr. Petroff said. “We trying to say, 'Don't dump real estate because it's down 20% and you're worried about further losses. Commercial real estate is doing what it is supposed to do.'”

Still, commitments are being made now for future investments. For example, Maine's newly expanded real estate allocation is to be committed gradually over the coming three years.

“By and large, it is not a rush of money in. Investors are changing allocations to take advantage of buying opportunities over the next three to four years,” Mr. Maher said.

Investors and managers do not expect a rush of investment opportunities for another few years.

Executives at LaSalle have their “antennae up, planning to start taking action in 2010, 2011 and 2012,” Mr. Maher said. “Values declined 35%, and we expect they will eventually go down by 40% to 50%. At that point, returns should be very attractive.”

Much of the future investment opportunities might come from real estate investment managers that are forced to sell properties, industry insiders said.

Some $347 billion of real estate bank debt and $1.4 trillion in commercial mortgage-backed securities are coming due within the next five years, according to the Oregon Investment Council's real estate annual plan, which cited an April 2009 real estate report by Deutsche Bank.

So far, this year the Oregon Investment Council, Tigard, had committed $22.5 million to real estate funds as of July 29, with three other potential commitments pending. The council committed $1.5 billion to real estate in 2008, according to its plan.

In 2009 and 2010, the Oregon Investment Council is considering investments in core properties with good cash flows such as trophy office buildings and apartment buildings in top locations from distressed sellers, the annual plan said. Debt investments, industrial properties, global value-added investments and selective secondary opportunities also might be on the table for the state fund.

“There are those (real estate managers) who will be forced to sell — into a horrible market — because of debt coming due, unextendable fund termination dates or redemption queues,” said Theodore M. Leary Jr., president, Crosswater Realty Advisors, Los Angeles.

Moving to core

Some investors are shifting to core from opportunistic and value-added strategies, waiting to pick up bargains. Earlier this year, for example, the $3.3 billion San Diego City Employees Retirement System changed its $477 million real estate portfolio's suballocations to 50% each for core and non-core, from 30% core and 70% non-core, as part of the portfolio's investment plan.

“If you don't need to sell now, you shouldn't sell. Most investors understand that and are trying not to sell. But there will be owners who will have to sell. And the easiest properties to sell will be the best assets,” said Wade Judge, LaSalle's chief investment officer, North America.

Those “best properties” have not hit the market in any significant amount yet, Mr. Judge said.