Market Watch – July 7, 2024

Investors trying to pull money out of commercial real-estate funds are hitting a wall

As the rush to exit commercial real-estate funds goes mainstream, more Main Street funds are putting up gates to limit withdrawals

Joy Wiltermuth || July 7, 2024

“A lot of investors are wanting out,” one real-estate consultant says.PHOTO: MARKETWATCH PHOTO ILLUSTRATION/ISTOCKPHOTO

Referenced Symbols

TMUBMUSD10Y 3.798% ↓ DJDBK -2.95%

The plight of investors looking to pull money out of commercial real-estate funds has gone mainstream.

Big-name property funds like Barry Sternlicht's $10 billion Starwood Real Estate Income Trust have been scrutinized for limiting investor withdrawals from niche funds that exploded in popularity among the well-heeled over the past decade.

But investors with millions of dollars at their fingertips aren't the only ones frustrated by funds putting up gates. Outflows and redemption queues also have been piling up at mainstream funds.

"A lot of investors are wanting out, but there are minimal distributions," said real-estate consultant Scott Maynard, a senior vice president at Meketa. "Until we start to see transactions pick up, we will see redemption queues in place."

Queues have hit roughly 95% of the commercial real-estate industry's benchmark "Odyssey" index, an equivalent to the S&P 500 index, according to a person with direct knowledge of the matter.

Its group of 25 private property funds, officially known as the NFI-Open End Diversified Core Equity, or NFI-ODCE index, has been around for nearly a half-century. The strategy appeals to pension funds and registered investment advisers as a lower-risk way to invest beyond bonds and stocks.

Yet Odyssey funds have been swept up by the same higher borrowing costs, falling property prices and wave of maturing debt that has roiled the broader market since 2022, when the Federal Reserve began jacking up interest rates to a two-decade high.

The National Council of Real Estate Investment Fiduciaries, which oversees the Odyssey index, doesn't track redemption queues or widely distribute its data on fund flows. A spokesperson, however, confirmed to MarketWatch that the group of funds had negative net flows for the past six quarters, starting with the first quarter of 2019, to the tune of almost $19 billion.

Nearly $60 billion has been raised for U.S.-focused real-estate funds since 2020, according to Preqin data through early June.

Adrianna Giesey, a portfolio manager at Russell Investments, said investors waiting in redemption queues have been receiving payments in "drips and drabs” since reduced transaction volume put pressure on liquidity at many core open-end funds.

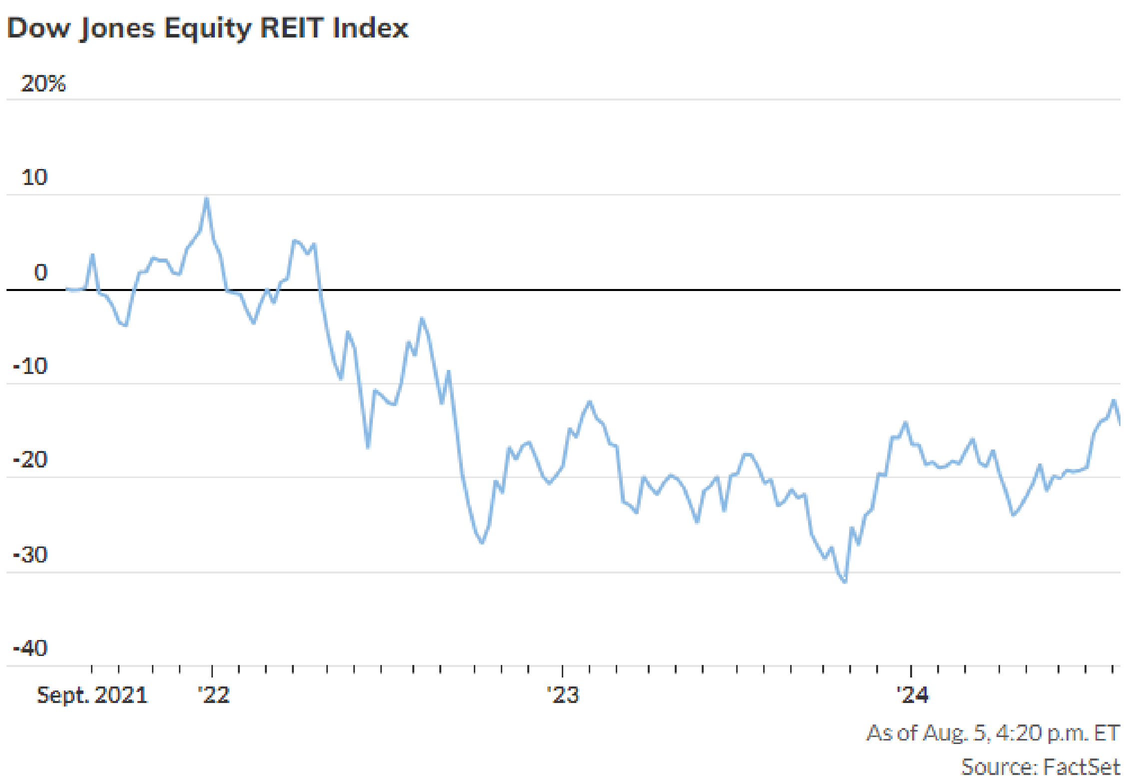
The U.S. has about 2,400 commercial real-estate funds dedicated to the five main property types, comprised of office, industrial, retail and hospitality, according to Chad Littell, national director of capital market analytics at the CoStar Group. Most focus on areas other than core strategies.

CoStar doesn’t track redemption queues, nor does Preqin, making it difficult to pinpoint overall redemption requests.

But one thing that could bolster confidence in the sector would be a Fed pivot to rate cuts, which is expected later this year. The hope is that steadier benchmark rates BX:TMUBMUSD10Y could help determine if property prices have finally found a floor.

Green Street pegged commercial real-estate prices as up 1% on the year through May, but 21% below March 2022 peak levels. RCA’s index had prices down 2.3% in May from a year ago.

In public markets, shares of the Dow Jones Equity REIT XX:DJDBK touched a bottom in October, and have been in recovery mode since.



“It’s been hard to find price discovery,” Giesey at Russell Investments said, speaking to the sharp drop in U.S. property transactions since the Fed began raising its policy rate to the current 5.25% to 5.5% range.

The Fed’s policy rate was close to zero during the COVID crisis and near historical lows for much of the past decade, a period in which most of the estimated $4.7 trillion pile of outstanding property loans were originated.

Typically, when a fund puts up gates, it works something like this: An investor with a $100 million exposure to an index might put in a $10 million quarterly cash-out request. Redemption limits, however, mean they might receive only $1 million back.

“Obviously, it is a challenge,” said Sara Cassidy, head of portfolio management for AEW’s private equity group. But while redemption limits can be frustrating, investors also don’t want to put a fund in jeopardy by requiring them to sell strategic assets to satisfy all redemption requests at once, she said. AEW is one of the sector’s largest managers, overseeing about $85.1 billion in real-estate assets globally.

When gates go up, investors get nervous and often put in bigger quarterly redemption requests than they anticipate getting back, which can paint a very ugly picture of cash fleeing a sector.

“I don’t think it’s all doom and gloom,” Cassidy said, adding that pockets of commercial real estate outside of office have held up well, and there’s a lot of dry powder on the sidelines that could be deployed if investors feel prices are near a bottom.

“I don’t know that is going to universally solve everybody’s problem,” Cassidy said. “But I don’t think everybody’s portfolio is problematic.”