KEYNOTE INTERVIEW

Shopping for retail money

Real estate managers have begun to target retail investors. However, the challenges involved suggest this route is not for everyone, says RBC's Dirk Holz

The private real estate funds management industry has historically focused on investing institutional capital. However, the largest global real estate general partners are now turning their attention to the relatively under-exploited retail investor market, which has had limited access to private real estate. This large pool of untapped capital could be transformative for the industry but will require managers to manage a new set of risks and think about their business in a different way. *PERE* talks to Dirk Holz, head of private capital services, product management at RBC Investor & Treasury Services, about these new developments.

Q How are real estate managers seeking to expand their capital base?

Historically, I would say, the main driver for real estate and also private equity and infrastructure was institutional money. We have seen significant growth in real estate assets under management over the past 10-15 years, which has come from institutional investors in funds and club deals. However, over the past 24 months, we have seen the global top managers starting to assess their future source of investment funds. There is a large part of the world's overall assets and wealth that has been largely ignored by private real estate managers and that is the retail space.

The definition of a retail investor is broad and might range from individuals investing $50 a month to high-net-worth individuals who might be happy to invest half a million or even more in a single vehicle. We are now seeing some new funds being designed to entice retail investors.

Q Do managers expect the flow of institutional capital to slow at all?

I think there will be even more institutional money flowing in. There have been a couple of regulatory changes in the US, particularly for pension plans, which are now allowed to invest more into real estate and other private assets. We are also seeing more liquid and listed money moving into the private asset or real estate space. In Canada, in particular Canadian pension plans, this is a trend we have been witnessing in the last 10-15 years. Some of these big pension plans have an allocation towards private assets and real estate of around 40 percent.

However, I think the competition is also increasing. Over the past five to 10 years, we have seen a huge consolidation of investments going to a few really big managers. Around 60 percent of the global money raised for real estate goes into the top 10 managers, which suggests there are untapped areas such as retail investments. Managers are looking at areas that are untapped. For example, retail investment in real estate via real estate investment trusts in the US and UK.

However, the exposure and the returns are not the same as those offered to institutional investors in closed-ended structures. Also very few retail investors can access private funds; for example, according to *Forbes*, only 2 percent of the US population is able to invest in private funds. Therefore managers, especially those with a large platform, are looking to roll this out into the retail market.

Q What are the challenges for managers looking to attract retail capital?

There are clearly some challenges. A traditional real estate fund is normally a closed-ended structure, with seven, eight, perhaps 12 years where the investor is committed and locked in for the whole life cycle of the fund. This is generally not what retail investors are really looking for; they always want to have a little bit of flexibility, which is why the stock market appeals to them.

This creates a challenge because if you are in the real estate space, by definition, these are illiquid assets. If you wish to liquidate a property, even though the process is faster these days than 10 years ago, there is still a bidding process and due diligence, and financing to be taken care of. I would say three to six months is quite usual and for bigger portfolios, it's even longer.

Managers which are opening up towards retail investors have to design a model that offers them some sort of redemption possibilities. Perhaps daily redemptions are not necessarily the way forward with an illiquid asset class – although you could allocate a percentage of the portfolio to more liquid assets, which could be real estate investment trust units for example or other real estate-linked liquid products.

However, by that, you're automatically taking away a bit of the performance, especially if you have to hold more cash. When you're investing in liquidity, you are not getting the same return as if you were investing directly into the assets.

We are seeing some managers moving into what you might call semi open-ended funds, where there is a notice period and some lock-up periods, which gives the fund a little bit more flexibility in the case of a redemption.

However, while these structures work in a good market, we have seen in the past that they are vulnerable in a downturn. For example, during the financial crisis in 2008, there was a run on some funds, because investors wanted to liquidate and get all their money out. This is exactly where this asset class has limitations because you cannot just sell a building overnight, and if everybody else is fire selling then sales are even more difficult to execute.

There are mechanisms and ways to get around these obstacles, such as lock-up periods and a queue of investors who only join when someone leaves, but this is the main challenge for managers – to manage the contradiction between a long-term investment and short-term liquidity.

As well as liquidity management, there will be an entirely different kind of connectivity between managers and retail investors. Reporting and the feedback from investors will also be different. Until now, the world of private real estate has been quite closed; it is a niche and so there is not much noise publicly about performance or transparency.

With more retail investment, there

Q Most managers said they were 'quite or very prepared' to manage liquidity in open-ended real estate funds in the case of a downturn. Does this seem realistic?

This is not just in relation to retail funds of course, but all open-ended structures. When there is a downturn or a global financial crisis as we have seen, there is significant pressure on managers because values fall, which affects loan-to-value ratios. And as we have seen in the pandemic, there might be sectors with falling rents.

However, I am not surprised that managers are pretty confident because managers have learned a lot over the last 10 years about how they can manage downturns. However, these questions around liquidity are rather different when a manager is operating with retail investor capital.

will also be more visibility of funds, which managers need to be prepared for. If retail investors go into these fund structures, you will read things on social media; there may be negative comments on the internet about a fund or manager. This will require a completely different kind of perspective, which perhaps the managers have not yet fully assessed and potentially even understood.

Q What type of managers are looking at products for retail investors?

In the retail space, the leading large managers have a big advantage. We have seen a rise in mega-funds, raising $10 billion or $20 billion, for global real estate mandates. People are talking about the possibility of a $100 billion real estate fund. The largest managers have the infrastructure to raise the money and to invest it as well. They can take on huge deals and portfolios. This gives them a completely different kind of investment power, a different kind of purchase pressure on the seller.

A lot of institutional investors love these mega-funds, because they automatically offer diversification and I think this will appeal to retail investors too. Another big advantage of the mega-funds is that they can deploy capital quickly, which means they face less of a challenge to manage liquidity.

Q Where does that leave smaller managers?

Smaller boutique or specialist funds, those with $500 million to $1 billion of assets, will always play a very important role. They tend to be very specialized, focusing on a sector, a geography, or a strategy – you might have a niche strategy looking at converting offices affected by the pandemic into housing.

Such strategies, by definition, have a different kind of risk profile but are very attractive for institutional investors who don't need diversification at the fund level because they have diversification in their own portfolio. These funds are offered by smaller managers, which are a different sort of business; they are very close to the assets and are very hands-on in generating value. Their funds have a more limited pool of investors who tend to be more active in their involvement.

> *"We are increasingly seeing that managers need global partners to assist them with their global portfolios of entities, assets and investors"*

Q Turning to the survey, were you surprised to see a fairly neutral response to the query about the effects of regulatory changes on marketing to retail investors? There was also a majority view that hybrid institutional/retail funds would be at least moderately successful in attracting retail investors.

It was surprising to me that most people were neutral on the effects of regulation, with more positive than negative, but I think it is partially explained by the relatively small number of managers who are looking in to launching retail funds. However, the Alternative Investment Fund Managers Directive, for example, will have a significant effect because it limits the ability of managers to market funds which are regarded as high risk to retail investors. It is slightly the same with regard to how hybrid institutional/retail funds will work – most managers are not yet thinking about this.

Q What changes do you see coming for managers, especially for those considering a move to take on retail capital?

We have seen managers doing a lot of fund services work in-house or using service providers to manage fund administration.

However, I think we are seeing more and more managers looking for support from banking players. This is because they can support managers with regard to fund administration and regulation, but more importantly, helping with cash and liquidity is in the DNA of banks.

As I previously mentioned, liquidity management will be the major challenge for managers looking to take on retail capital. For example, banks can offer bridge financing to help with capital calls. A lot of managers use non-bank players, which cannot offer that piece, so I think that need for liquidity support served by banks will be a differentiating factor.

The reporting side will change; we have already moved from annual to quarterly or monthly reporting and we may see even more frequent reporting to aid redemptions. There is also a lot of data, which is not structured or even readily available. Managers and service providers are working to make more of this available and there is also a need, not just to use it, but to add value… Both the redemption and reporting environments will be different due to the scale of retail investment. An institutional fund might have between five and 50 investors, but a retail fund can easily have 10,000.

We are increasingly seeing that managers need global partners to assist them with their global portfolios of entities, assets and investors. As well as a global presence, a crucial part of this service offering needs to be technology; especially to support managers on reporting. These changes in the operating environment of managers will all be affected and accelerated by a move into the retail investor space. ■