

Private Equity & Principal Investors Practice

A turning point for real estate investment management

As institutional investors flock to real estate, investment managers must avoid getting stuck in the middle of the market—too big to be nimble yet too small to reach scale.

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At \$3.1 trillion in assets under management (AUM), real estate is one of the largest alternative asset classes (Exhibit 1). Sustained, high single-digit growth in AUM has been driven as much by investor appetite as by strong asset-class performance. LP allocations nearly doubled from 5 percent in 2005 to 9 percent in 2017.¹ Investors have flocked to the asset class because of the perception of equity-like returns, relatively high cash yields, and lower correlation with broader capital markets.

Even after massive capital inflows, the sector continues to enjoy a structural tailwind, as LPs remain underweight relative to long-term targets (Exhibit 2). One reason might be that, as LPs have told us, few managers are well positioned to meet their evolving

needs and to give LPs confidence in alpha generation at a time when capitalization rates are low. Still, recent surveys indicate that many LPs expect to increase their allocations to managers they trust, and capital appears likely to continue flowing from new sources (for example, retail investors).

How exactly are the needs of LPs evolving? We see four trends:

- *Risk off, yield up.* As a share of their real estate allocations, LPs have traded down the risk spectrum in the years since the global financial crisis. Allocations to core, core-plus, and debt strategies have grown more quickly than value-

¹ Preqin.

Exhibit 1

Real estate is a \$3.1 trillion asset pool.

2018 real estate investment management market,¹ \$ billion (total market size: \$3,143 billion)

By geography

North America 1,891	Europe 853	Asia-Pacific 399
60%	27%	13%

By strategy

Core/core plus 1,731	Opportunistic 691	Value added 537	Debt 184
55%	22%	17%	6%

¹Gross assets under management (excludes listed securities).

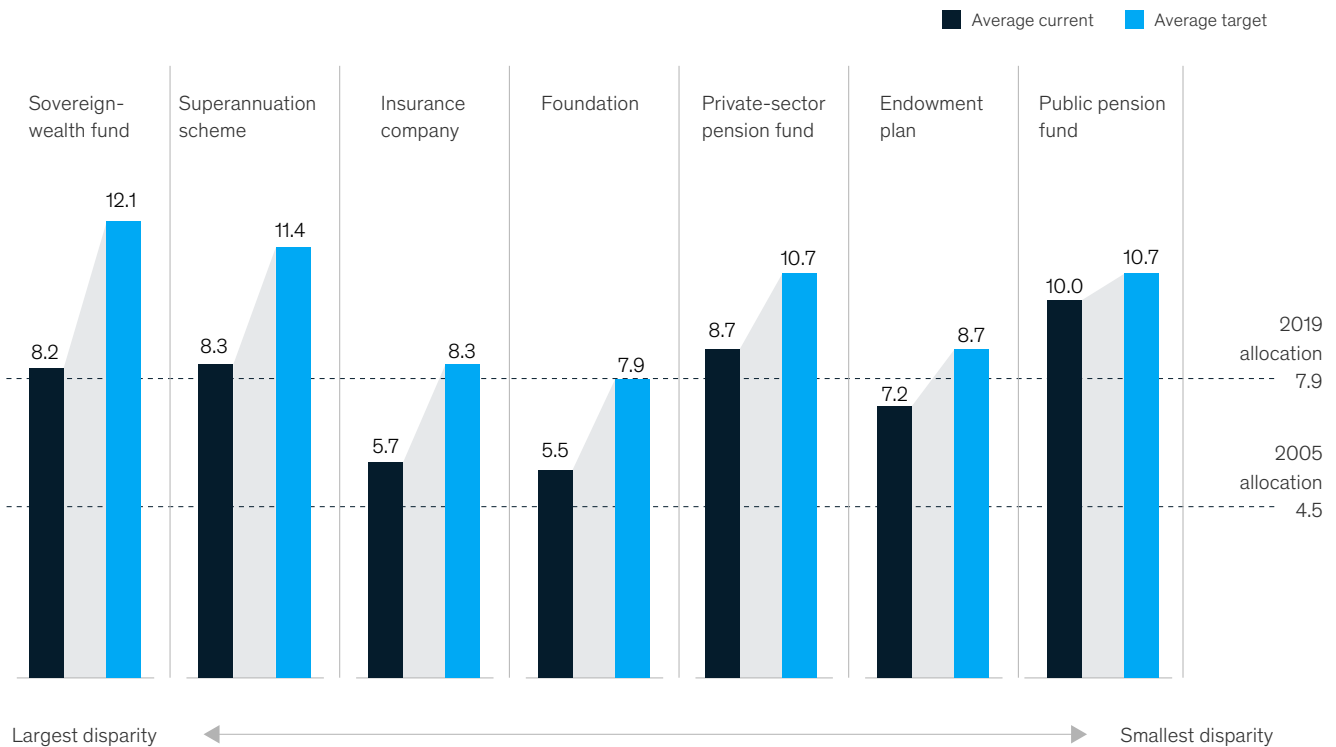
Source: Institutional Real Estate; MSCI Global Quarterly Property Fund Index; Preqin; McKinsey analysis

Sustained, high single-digit growth in AUM has been driven as much by investor appetite as by strong asset-class performance.

Exhibit 2

Real estate allocations have room to grow.

Investors' average allocations to real estate in 2019, %



Source: Preqin; McKinsey analysis

add, opportunistic, and distressed strategies (Exhibit 3). One likely reason is a search for yield, as many investors have rotated away from sustained low yields in traditional fixed income. Even with recent Class A stabilized cap rates in the range of 5 to 7 percent, core real estate has provided a 200- to 400-basis-point spread over ten-year Treasuries (and also did well through the last downturn).² While that has attracted much interest, lower expected returns in core strategies, driven by compressed cap rates, have prompted a shift to core plus. One early-moving core-plus fund has grown massively, and others are quickly following. For LPs, core plus might be said to combine the yield of core with the opportunity to outperform the leading benchmark³ referenced by most pensions and their investment teams.

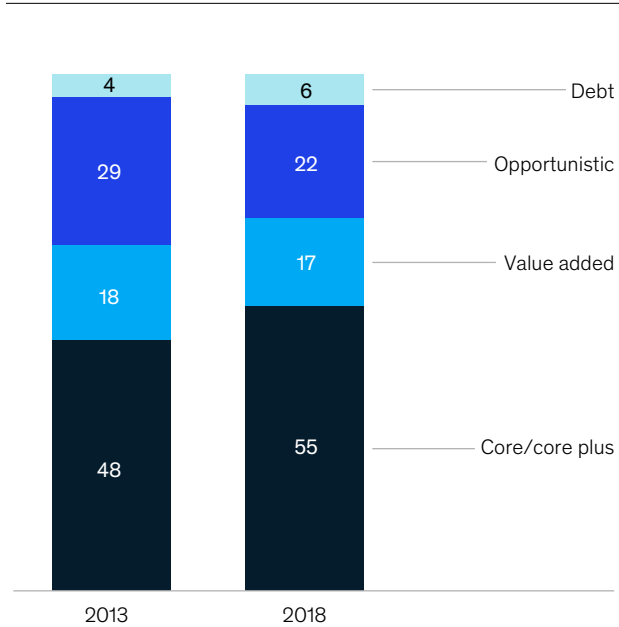
- **Long-term capital deployment.** Open-end funds have grown at 18 percent annually in the past five years, as GPs have favored capital without a set hold period. Their share of core and core-plus investment grew from 21 percent to 28 percent during that time (Exhibit 4). Private equity-style closed-end structures are not dead; indeed, fundraising has recently accelerated, particularly for opportunistic funds. But the permanent nature of open-end vehicle capital and incremental cash flow over time have led to greater share for these vehicles. In keeping with the broader shift across most private markets, the traditional drawdown vehicle has lost ground to more flexible structures.
- **Growth in direct investing.** Many larger, at-scale LPs have built in-house capabilities, increasing control and discretion through separate accounts, discretionary sidecars,

² "North America Cap Rate Survey H1 2019," CBRE, Half 1 2019, cbre.us.

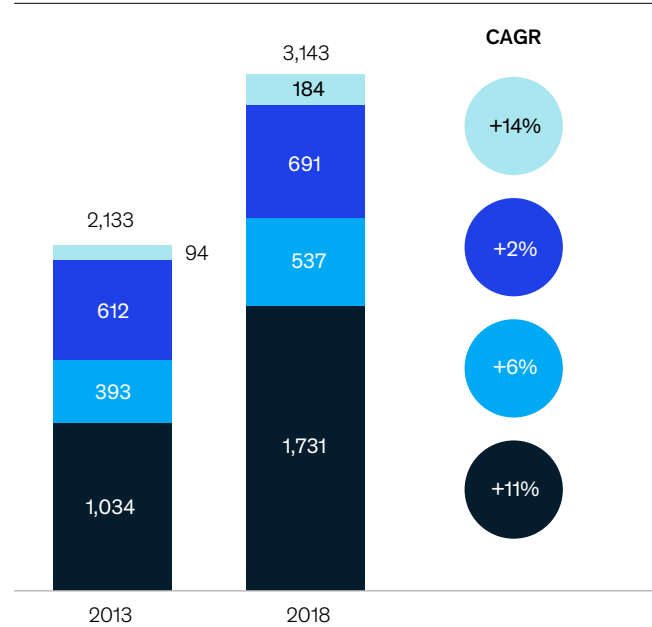
³ The NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE), based on more than 35 large open-end and commingled core US real estate funds.

Flows are shifting to income-oriented strategies.

Real estate gross AUM¹ contribution, by strategy, %



Real estate gross AUM contribution, by strategy, \$ billion



Note: Figures may not sum, because of rounding.

¹ Assets under management.

Source: Preqin; McKinsey analysis

coinvestments, and direct investment through large-scale joint ventures (JVs). Others are tying up with operating companies, either by buying them outright or by investing through exclusive agreements. By increasing allocations to more-direct strategies, LPs both lower their costs and retain greater control over decision making and cash-flow timing—both attractive attributes. Many large LPs will continue to invest in funds and look for partners that can service their full range of needs (such as one-off development JVs). Smaller LPs (which represent the majority of capital) still rely on commingled funds.

- **Net returns, not just gross returns.** LPs are looking for ways to get exposure to real estate but will only pay for higher cost structures that also deliver consistent alpha. While some managers are meeting that need, the push for lower costs has led to rapid growth in AUM of several very large investment managers (IMs)—most notably, funds sponsored by insurance

companies and traditional asset managers, both of which often benefit from balance-sheet capital and in-house distribution networks. These embedded advantages provide scale economics to these players, allowing them to compete with relatively low fee structures (typically without a promote). As these investors grow larger, and the institutional-investment landscape grows increasingly fee averse, managers with higher cost structures will be further pressed to justify their fees through differentiated value propositions and proven ability to outperform through cycles.

How can investment managers respond?

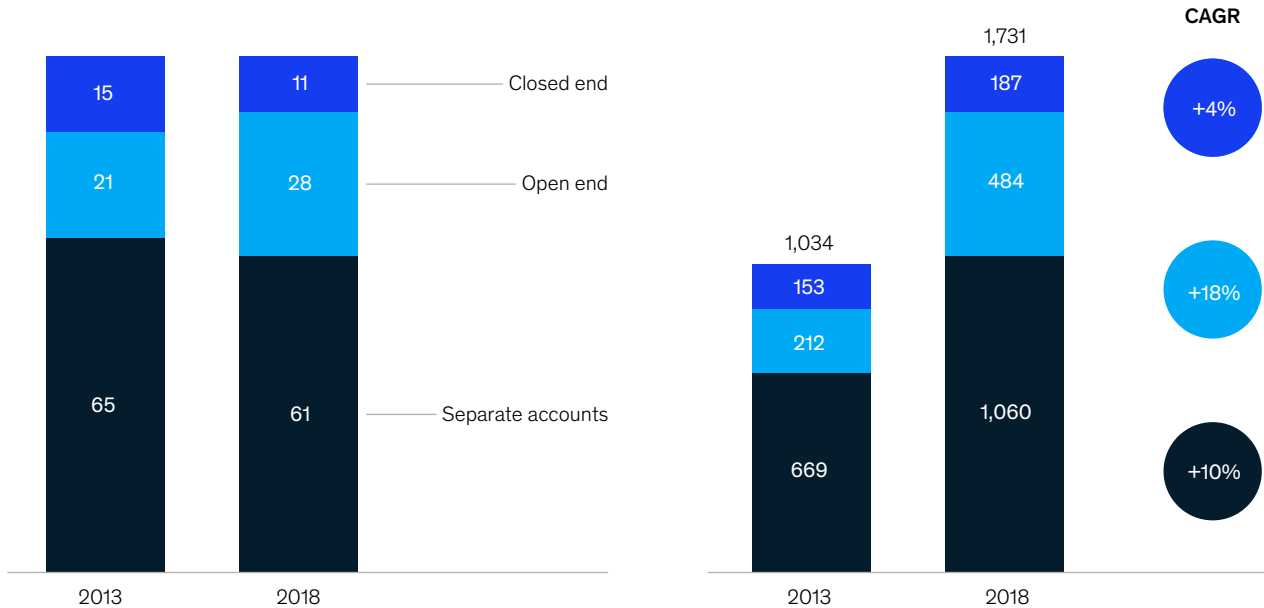
The needs of LPs are evolving, and some managers have adapted better to the new environment. A few such firms have collected more capital—and have transformed this newfound scale from a simple outcome of their success into a genuine competitive advantage. Other managers have distinguished their

Exhibit 4

Within core, capital has shifted to open-end funds and separate accounts.

Core/core-plus gross AUM,¹ by subsegment, %

Core/core-plus gross AUM, by subsegment, \$ billion



Note: Figures may not sum, because of rounding.

¹ Assets under management.

Source: Preqin; McKinsey analysis

firms by developing unparalleled expertise (and, often, operating capabilities) in niche segments (see sidebar, “The evolving landscape of real estate investment management”).

Across the spectrum, from niche to scale, LPs’ changing needs are resetting the industry’s dynamics. In response, we see five ways for IMs to differentiate and grow profitably:

- **Meet investors across the risk spectrum.** Capital has shifted to core and core-plus strategies, but many of those dollars are run by managers that have moved down the risk spectrum to meet investor demand. Gone are the days of single-strategy at-scale managers in real estate and across private markets. Winners today are flexible in what they do, and excellent opportunistic investors can convince investors that they can perform in value-add or core-plus strategies (as evidenced by capital flows). In our view, the

lesson is not just about meeting the current demand for core-plus strategies but also about building the capabilities to play across the risk spectrum, using their hard-earned reputations and investor relationships to play an outside role in LP portfolios, regardless of market conditions and favored strategies.

- **Build analytics capabilities.** Real estate investors and operators sit on an enormous set of data about each of their properties and many more in the industry. Further, nontraditional data sources promise to illuminate even more insights. Are multifamily rents in a given zip code more sensitive to the number of five-star restaurants in the area or to the proximity to gas stations? Answers to such questions are now knowable, and forward-leaning managers will create a meaningful data advantage from simply utilizing what is already captured, even when stored in cumbersome formats. Underwriting with data-backed conviction could help managers

pick better buildings and invest in second-tier cities, out-of-favor submarkets, and emerging specialty segments, expanding the opportunity set. Furthermore, the use of data to drive tenant selection, revenue management, and so on can produce significant operational outperformance and free up cash for capital investment.

- *Build a set of strategic anchor partners, complemented by a long tail of investors.* Large institutional investors are looking for strategic

relationships with managers in which they can deploy big pools of capital across a range of opportunities and access a range of services that go well beyond the product, such as research, analytics, and advice on their portfolios. IMs that build global relationships with a few top LPs as anchors will have advantages when launching new strategies and investing in new geographies. Vertically integrated managers that can partner with LPs for both their direct and traditional needs may be particularly advantaged.

The evolving landscape of real estate investment management

Of course, what it takes for investment managers to win will vary by their model. Today, real estate investment firms can be broadly distinguished along two dimensions: investment scope and degree of vertical integration (exhibit). Firms' scope ranges from at-scale offerings (delivering products across food groups, or property types, in multiple regions) to specialist offerings (in a single asset class or single region). Their roles range from pure capital allocators (relying on third-party operators to source, execute, operate, and dispossess) to vertically integrated players that do it all. Each of the resulting four segments requires a different set of competencies to win.

Many of the at-scale allocators are financial-services firms, such as insurers, which have large balance sheets and have historically deployed part of their captive capital reserves into real estate. Over time, many have accepted external capital to get more leverage from their high-quality investment teams, complete more and larger transactions, and capture investment-fee income. Winning as an at-scale allocator requires three assets: the ability to acquire portfolios (rather than single assets) systematically, a high-speed investment process to deploy capital rapidly, and low-cost infrastructure.

Many alternative asset managers are specialist allocators. Such firms tend to cross-sell real estate with other alternative assets, such as conventional private equity and direct lending. They excel at identifying opportunities and at financial engineering, relying on operating partners to develop, renovate, and manage the assets from day to day. The most successful specialist allocators have trusted relationships with a narrow set of operators; these arrangements typically offer true proprietary deal flow and reduce the need for operator diligence, cutting the time needed to bid for and win a deal. They also focus creatively on specialty real estate and building operating platforms.

Specialist operators are typically investors and developers with committed third-party capital that execute targeted investments within specific niches—often at the intersection of an asset class and region. These firms win when they possess deep operating expertise—often, proprietary site-selection skills, best-in-class asset management, or disciplined capital expenditure.

Finally, generalist operators combine operating expertise and scale across asset classes and regions. Very few firms have

succeeded in joining this segment, and indeed, the segment itself has emerged only fairly recently. To excel, firms must combine at-scale investment processes for both single assets and portfolios, operating capabilities to generate alpha, and an in-house fundraising machine capable of both flagship funds and smaller vehicles. Those few that have succeeded, however, have done so in an outsize way, reflected in both the top line (where they attract capital faster than others) and the bottom line (where they capture more fees than others, in the form of asset-management fees as both the capital and operating partner, and asset-level fees). In the future, this segment is the one where we expect breakout asset growth to concentrate.

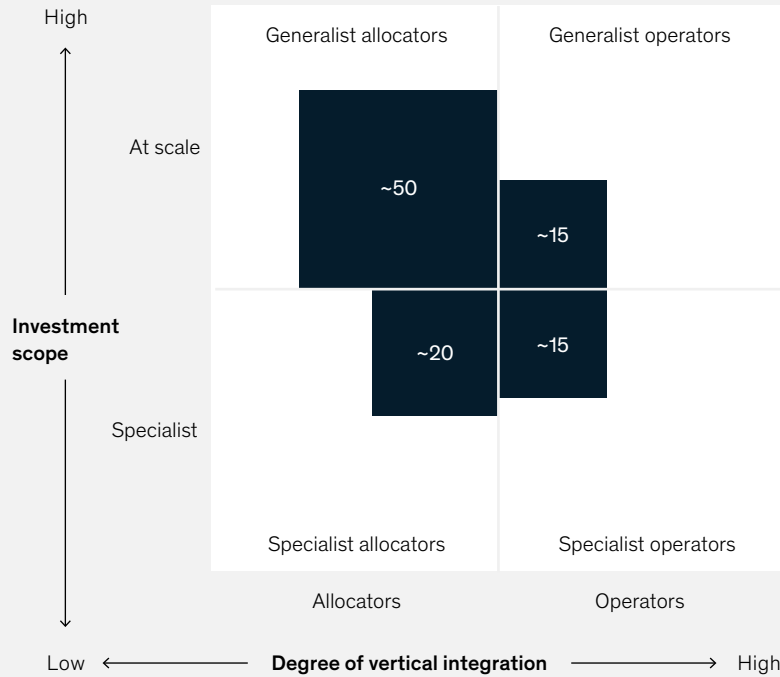
LPs, for their part, have more choices than they've ever had, including managers, asset classes, fund structures, coinvestments, separate accounts, joint ventures, and more. As the landscape evolves, understanding the strategy employed by each manager may help inform the search for investment performance.

The evolving landscape of real estate investment management (continued from page 70)

Exhibit

A new GP landscape is emerging in real estate.

Real estate investment management (REIM) assets under management,¹ %



Generalist allocators

- Massive scale and low costs allow competition on the basis of lower fees (requiring continuous scale to combat ongoing margin compression)
- Usually need capability to acquire portfolios (not just assets) systematically and high-speed investment process for capital deployment



Specialist allocators

- Excellent at opportunity identification and financial engineering (relying on operating partners for execution); often cross-sell real estate with other alternative asset classes (eg, private equity, direct lending)
- Generally have trusted relationships with a narrow set of operators



Specialist operators

- Targeted investments in their niche (often at the intersection of a subsector and region)
- Competitive advantage underpinned by value-accretive expertise (eg, site selection, property management, capital-expenditure deployment)



Generalist operators

- Combine operating expertise and scale across subsectors and regions
- Require at-scale investment processes for assets and portfolios, operating capabilities to generate alpha, and in-house fundraising machine

¹ Includes both captive and raised capital. Excludes open-ended funds.

Source: Institutional Real Estate; MSCI Global Quarterly Property Fund Index; Preqin; McKinsey analysis

Anchor partners are helpful but not sufficient. They jump-start funds and fundraising—but typically at discounted rates. A longer tail of investors is required for funds to reach profitable scale. Such investors typically invest in funds only. Winning with the long tail requires a credible track record and an exceptional sales force—something many managers lack. Retail, in particular, is a significant opportunity: we estimate that, in the United States, high-net-worth investors' unmet need for private real estate ranges from \$50 billion to \$100 billion. Accessing this capital requires matching investment products with liquidity needs (as private real estate investment trusts do) and partnerships in the right channels (such as wirehouses, private banks, and retail investment advisers). In this way, IMs can use centralized, shared resources to create scale economics to access an investor base that pays nondiscounted fees.

- ***Invest behind transformative themes to reach scale.*** With large-scale demographic shifts and significant changes in how we live, shop, work, and play, disruption has come to every food group. As an example, the aging stock of core office towers in major cities was not constructed to meet the demands of open floor plans, shared spaces, or short-term leases. Beyond traditional segments, these contemporary needs are also increasing the demand for specialty products (such as data centers, senior housing, and e-commerce distribution centers). Especially in the late stage of the cycle, IMs cannot sit around and wait for the perfect asset to arrive. They must focus on proactive theme generation and find portfolios of assets to deploy capital at scale.

- ***Go international.*** Leading GPs today are truly global, with acquisition and operating capabilities around the world. The most successful managers are replicating their successful domestic platforms, often by exporting a concept such as build-to-rent multifamily. They are serving the needs of cross-border tenants such as e-commerce companies. And they are relying on the trust given by their LPs to enter foreign markets with confidence in their ability to spot good practices and opportunities in less familiar markets.

Of course, pursuing any of these five growth strategies introduces operating complexity and a need for new capabilities. If not managed well, then growth—raising more capital from more investors, deploying that capital in larger transactions and in new markets, and adding analytics capabilities—will both add costs and increase investment and operational risk. In a world where fees are compressing, increasing costs is not a winning formula. To grow profitably, GPs must ensure that scale truly brings about operating leverage (especially through efficient general and administrative functions that utilize digital tools, process automation, and thoughtful outsourcing strategies).

Real estate is in a period of substantial disruption and growth that has already created big winners and stands to create more. To break out from the pack, IMs should lean into the disruption, embracing new asset types, food groups, vehicles, and partners. Those that do are set to deliver differentiated performance and build scaled, sustainable businesses.

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