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GT Roundtable: Real Assets, Time for Another Look?

Welcome back to Part Two of our interview series with the GT private markets team (Bill Ryan, Kojo McLennon, and Sean Montesi) on real assets. We recently sat down with the three of them to talk about portfolio allocation and strategy, sourcing investment ideas, and a few historical case studies. Part One can be accessed here if you missed it: https://www.gerbertaylor.com/insight-info/gt-roundtable-real-assets-time-for-another-look.

How do you think about valuations for real assets in an absolute sense and relative to other asset classes right now?

Sean: I think if we take it category by category, traditional real assets look on the cheapish end of things. There was a historical washout during COVID, and real assets looked generationally cheap: after some recovery, they look relatively cheap now. Renewable energy went from being overvalued to more fairly valued. In real estate, I think we're in the midst of some repricing right now. We've seen REITs fall about 25%. I don't think private markets have repriced quite that much yet but are directionally heading the same way as REITs.

Kojo: Valuation questions are a tough one. I think we're at a point where it's really asset by asset…or situation by situation. Meaning, if we had dry power today, it doesn't mean we would not be doing anything. Quite the opposite. I think we would be hunting for good opportunities through our managers and particularly with managers that have quite a bit of valuation discipline and have their eyes wide open to the risks that lie ahead. It's really kind of like before 2022 started to happen, before the Fed started raising interest rates, the blanket answer was assets are more than fully priced. Now, things have changed, and we don't know how long those changes are going to continue before the market settles down, but that never means that there's nothing to do.

Bill: And we love the fact that we're finding groups which borrowed too much money. As rates go up, they're going to need some sort of financing help. We provide capital to those who will provide that help. We really like those strategies – good assets with bad balance sheets.

Kojo: For example, before this year, I hadn't heard of the term "upside-down leverage", which means that the rate on the debt on a multifamily asset is higher than your net operating income (NOI) yield for that property. That's starting to pop up. You may own a really good asset, but if you overpaid for it, and you've got relatively expensive debt, the markets are turning against those kinds of assets, especially if you have floating rate debt in the capital structure. I can think of other scenarios where rookie mistakes are being made in terms of capitalizing good assets, which will create opportunities for better placed managers. I don't think that's so different from what you might say about the equity market right now. At this inflection point, winners and losers are being created. Just like in distressed equities, where we see good companies with bad balance sheets, we're talking about the same thing on the real estate side.

Bill: Senior living is a good example. We had a demographic trend thesis in senior living; then COVID hit and nobody checked into a senior living facility for a year and a half. That same demographic just got a year and a half older, so that's still in our favor.

We really believe in active management in the space. Could you expand on why that's important?

Kojo: Yes, it's very important. Going back to the trends thing, we know what the trends are, we always are aware of what the trends are, but we're not in a position where we can predict what these trends will be. However, we believe many of our managers can, because they focus their research on their niches. For example, one of our managers found an opportunity to invest in industrial assets in Western Europe. They observed the trends of e-commerce penetration and the need for warehousing, and last mile logistics that existed in the U.S. They observed that the U.S. market was becoming crowded, mature, fully priced, if not overpriced, but there was a big opportunity for the same strategy to be implemented in Western European cities like London, Paris, and Berlin. They found who we believe to be an experienced operator in that region and created a special opportunity vehicle for us to invest in. We could never do that on our own, but we try to find these sharp shooters that are able to identify these opportunities and have a wide variety of experience to execute on them. That's the importance of the managers. Now there are a lot of managers in these spaces and our job is to try to find those that are capable and trustworthy.

Bill: We view this similarly to how we view private equity. There's value in the sourcing and operational expertise in these managers. An apartment complex in Charlotte is a great example. It literally burned down, so we bought it from the previous owner who suffered through the fire and didn't want to rebuild. We came in with a manager who already owns a large portfolio of apartments and who was ready to fix them. Once you fix them, then you can start charging market rents. That only happens through active management.

Sean: I think active management is most important in markets where there is wide return dispersion. Private markets, generally speaking, have return dispersion.

The managers are key, so how do you source these investment ideas?

Bill: One is from our family network. Most of our investor base are high net worth families. Those families tend to have extensive real estate ownership, so that's one way.

Kojo: Our broader Gerber Taylor investment platform is another. We've sourced real asset managers from our hedge fund relationships. Some managers may spin out from an existing manager, and they could be worth backing. We also get a lot of inbound phone calls, and we vet as many as we can. After initial screens, we identify which ones that we believe have promise and which ones don't. Generally, the funnel is very full at the top, and we gradually filter that through to an investment recommendation. But we also have our own networks. Bill, Sean, and I have distinct networks that result in new opportunities coming our way. We're never lacking in things to pursue and, in the real assets area, it's just a matter of being diligent about getting them thoroughly vetted and trying to make sure that they fulfill characteristics that we're looking to recommend.

Bill: The best way to illustrate these are examples. We received a phone call one November from one of our hedge fund managers who was looking at a single-family rental deal that had to close by Christmas. We were willing to fly to where they're located, underwrite it alongside the hedge fund manager, and invest with them.

How are you thinking about portfolio construction in terms of investments in managers versus co-invests and directs and also public versus private? I know you plan to be opportunistic, but big picture how are you thinking about it?

Bill: Geographically speaking, it will probably be predominantly in the U.S. But again, there will be pockets of opportunity in other places and other segments like we've seen in the past.

Sean: Maybe as a starting place as we think about the past real assets investments, I don't think it will differ wildly from those. Maybe 50% real estate mixed between commercial and residential. The other 50% with energy being the biggest component, then infrastructure, and something opportunistic that we may not have done before. We've done metals and mining before, occasionally we review timber land but frankly do little in these areas due to elevated concerns about manager quality and liquidity. We've become increasingly active looking for direct investments.

Why have we considered more direct investments over time and what kind of characteristics are you looking for when selecting certain opportunities?

Sean: One thing, not the driving force, but directs tend to cut down on the fee drag by being closer to the asset. We are better able to underwrite the asset in a direct investment as there's always some degree of blind pool risk associated with funds. We also expect there's an opportunity to cut down on the J-curve as we're typically able to invest immediately.

Kojo: One of the attractive things about some of the direct investments that we've executed on is they come with compelling dynamics. Like the Charlotte apartment, which was distressed and in need of rescue operations but was located in an up-and-coming neighborhood. We had a similar situation with the same manager with their Collierville, Tennessee apartments which had an international owner that needed liquidity. This allowed us to step in to be the replacement equity in that situation. These are almost like special situations opportunities that we can underwrite with groups that we've known for a long time and that have a lot of experience. It gives us a lot of comfort knowing what the underlying assets look like on the front end and what the road map should look like towards value creation. We did that recently with an energy transaction too, and we think we're going to continue to see more of those transactions in the future. To the downside, these deals require a great deal of diligence over a short period of time, so we are highly selective. And if we don't select well, we've concentrated capital in an unfavorable asset.

Historically, portfolio construction has skewed heavily illiquid, why is that and how do you think about private versus public real assets?

Bill: Yes, I think one of the attributes of private real assets is you don't have to price it every day. We look for assets that will generate cash flows that will get paid out over a period of time, and then sold for capital gains. I don't want to say the intermittent volatility doesn't matter, but it works similarly to private equity.

Can we take a past investment or two and profile it - maybe speak to where it came from, why you liked it, and how it turned out?

Sean: We talked about infrastructure earlier and our experience has moved a little bit more towards value-add approaches. We have a relationship with the former Allstate real assets team which invested on balance sheet and had multiple years of experience there. They are a really good team, working for a company that was good at selling insurance, but there was a misalignment for those guys - they were not properly incentivized, so they spun out. They're trying to find infrastructure assets that will ultimately be attractive to the institutional buyers. They look for projects that need some additional development or improvement, or just aren't quite to scale yet to be attractive to larger buyers. It is not too dissimilar to how we think about lower middle market private equity and how businesses are prepared for sale to bigger private equity and strategic acquirers. This group has a particular focus or niche in water. As we think about essential infrastructure, there is probably none more essential than water, you can't live too long without it. One of the things that got us most excited about this group was that a big asset in their first fund was a water pipeline to supply 20% of a southwest city's water needs. This city has had habitual drought conditions over time and the group alleviated that in building this pipeline from an aquifer from another part of the state into the city.

The group has a 30-year contract with the city, and the pipeline is now up and running and has been for some time. If there's several years of operating history, they can sell that to somebody for a much higher price than at what they created the asset.

Bill: The second example would be a Dallas-based firm specializing in distressed commercial real estate and senior living where we recommended an investment in their third straight fund over about twelve years. The thing that drew us to them was one of the managing partners had experience at Colony Capital. He left Colony to start his own fund. In the process of that, he also owned a special servicer which provided phenomenal access to deal flow. Honestly, deal flow was very robust in 2008 and 2009, but assets began to get picked through and began to dry up by about the 2013- or 2014-time frame. The firm did a fantastic job of shifting away from that and into senior living facilities based on the demographics and based on the experience of their other partner who built a career investing and providing capital to senior facility operators. The beauty of this thesis is the operational aspect: families don't choose senior facilities because they're owned by a conglomerate, they choose them because they're clean, they're safe and they're close. Location selection and operations of those facilities are critically important, and that's what this group does extraordinarily well.

Sean: And while those are investments that have been working out, they don't always. In 2013 and 2014 we made a couple energy-related investments, one in a fund making negotiated debt and structured equity investments in oil and gas companies, and another in a portfolio of publicly-listed MLPs. In both cases we probably underestimated the degree of commodity price risk inherent in the strategies. As it turned out, these investments were not well timed – the price of oil and natural gas fell rather precipitously in late 2014 into 2015 and stayed low for an extended period, pressuring most business models tied to oil and gas. Having had that experience, I think we've subsequently approached the space with a heightened degree of scrutiny and return requirements, as well as found ways to invest in related strategies with lesser commodity sensitivity.

Anything else you want our readers to know about real assets?

Kojo: We aren't trying to hit home runs in this category. I think investors sometimes lose sight of the benefits of this asset class. It has these dynamics that you don't get with equities or hedge funds that we believe are important to have in a portfolio. Those benefits don't diminish the risk of adverse manager or asset selection, but when you start to consider the changes in the broader market, it's an important asset class that we think ought to be strongly considered.

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Tara Elliott & Andrew Fox

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