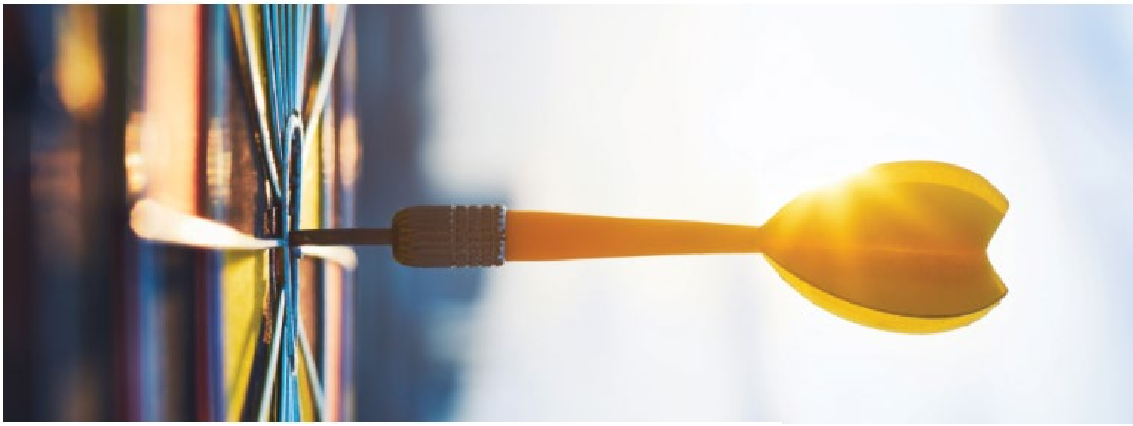

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Hitting the mark: Demand for better representation of niche assets in benchmarks continues to grow, but delivering accurate sampling remains some way off

BY MAREK HANDZEL

Real estate benchmarking has been dogged by problems since its very inception.

Investors have commonly bemoaned a lack of transparency, sample degradation created by market changes, the ineffectiveness of risk measures and the rate at which data is updated — particularly when compared with benchmarks in other asset classes.

These problems were encapsulated in a major report by U.K.-based Investment Property Forum (IPF), which was published in late 2018.

The authors of *Current Practices in Benchmarking Real Estate Investment Performance* recognized the need to improve the sector's use of performance yardsticks. "Looking to the future," they wrote, "[we] believe that the challenge is to design a system that can cope with changing market conditions. It should also deliver a good balance between the measurement and attribution of performance that adequately captures risk and return combined with the position of the portfolio in the contemporary real estate cycle."

Despite the criticism leveled at them, benchmarks remain in widespread use simply because they are recognized as a vital tool. As Willem de Geus, chairman of ANREV and founder and partner at Proprium Capital, highlights, real estate makes up between 5 percent and 10 percent of most large institutions' investment portfolios, and is constantly competing with equity and bond allocations.

"If you've got nothing to show for your investment, then you're never going to stand your own ground based on the performance that you have delivered," says de Geus. "It's incredibly important from an asset-allocation-call point of view."

Furthermore, he says, within a pure real estate context, no matter the avenue through which capital is funneled and no matter what type of strategy an investor is pursuing, the need to understand an investment's risk profile remains paramount. "You need these time series to determine if you are getting proper risk-adjusted returns," he says. "Those type of insights [are needed] to be able to show how your portfolio is doing versus the market, and how your manager is doing against the rest of the market."

Emerging issues

The first official real estate benchmark was launched in 1982 in the United States — the NCREIF Property Index (NPI). With data going back to 1977, this appraisal-based index only covered four asset classes: office, retail, multifamily and industrial.

Today, those sectors remain the dominant players in most benchmark sampling, but their pre-eminence grows ever more anachronistic with each passing quarter, as investors continue to pay increasing attention to niche assets, such as data centers, self-storage and single-family housing. In the minds of many investors, this has created an imbalance in indexes that needs urgent addressing.

As one U.S.-based investor, who wishes to remain anonymous, told IREI earlier this year, he and his peers are finding the lack of a relevant benchmark for "other" property types a gnawing frustration. "I'm currently comparing my niche properties to the NPI because there isn't a good private benchmark," reveals the investor. "LPs could also use the specialty [REITs], but the volatility of public doesn't match private assets."

According to IREI's *2021 Annual Investor Survey,* biotech/life sciences, data centers and cold storage are among the most attractive property types to institutions, with office and retail trailing far behind. Once the COVID-19 crisis is cleared, this picture may change somewhat, but the trend toward more alternative property types was well in motion before anyone had even heard of SARS-CoV-2.

Real Capital Analytics (RCA) has found some alternative property sectors breaking transaction records with ease. Globally, slightly more than $11 billion had been spent on life sciences R&D properties by June of this year, compared with $16 billion in the whole of 2020, which was the second strongest year on record. And deals involving U.S. self-storage assets reached a new high in 2020, despite the disruption and uncertainties caused by the global pandemic. At $7.7 billion for the year, self-storage deal activity was one-third higher than that of 2019.

Elsewhere, RCA notes investors in Australia allocated more capital into alternatives in 2020 than ever before, with the amount spent on sectors such as student housing and data centers surpassing that of conventional office properties. Alternative sectors attracted more than A$8 billion ($6 billion) in investment, and their share of the total market reached 29 percent, from an average of 8 percent in the previous three years.

RCA also has found alternative property types — in all their various guises — now account for up to 11 percent of transaction volumes in Europe.

This growing activity has naturally coincided with ever-larger funds that focus on niche property types. According to the IREI.Q Database, these include Keppel Capital's second data center fund, which covers Asia and Europe and has a target close of $1 billion, and Harrison Street's Real Estate Partners VIII opportunistic fund, which invests across the United States in self-storage, medical offices and healthcare, among other sectors, and hopes to close with about $2 billion of capital.

Representation

Nevertheless, this uptick has yet to translate into the industry's most prominent benchmarks.

"Our benchmarks, by definition, reflect what our clients are invested in," says Will Robson, global head of real estate solutions research at MSCI. "The majority tend to be the institutions that have been holding assets in more open-end structures and segregated mandates, that tend to be more at the core end of the spectrum than the opportunistic end of the spectrum. And it's still the case today that the majority of those portfolios are made up of office, retail, industrial, residential. The slice of the portfolio that is niche has been growing steadily over time, but it is still low exposure, relative to the amount of talk there is in the market."

The good news is that concrete action is being taken to address gaps in benchmarks. Starting in the fourth quarter of this year, any firm that submits to the NPI will have to report on some property subtypes that have become more prominent during the past few years, most notably medical office, senior housing, lab sciences and data centers.

Some anomalies and cracks remain, however, says John Caruso, global head of fund finance for Nuveen Real Estate and chairman of the NCREIF reporting standards council, as well as co-chair of the global standard steering committee.

"For instance, in the NCREIF office sector, medical offices are included, but a life sciences building is not," he points out. "Some would say that it should really be part of the office sector. But the NCREIF committee decided to keep that as part of 'other,' so it's still going to track it, but it should be in 'office' not 'other.' Then there are sectors such as single-family rental and build-for-rent, which are hot topics in the industry right now, but they haven't got around to really look at them yet."

Part of the problem is the very nature of niche sectors and the vehicles they sit in. As Robson says, it is difficult to obtain data due either to a lack of willingness or ability to supply information from closed-end funds. Another issue is the assembly formed around niche assets, such as those found in the listed markets, which tend to have a lot more exposure to alternatives in general. "With REITs, you literally have the management platform and the assets tied together in one investment. Maybe these sectors lend themselves more to those kind of structures than they do the core open-end vehicles or the directly held assets of asset owners that we measure now on indexes.

"You have day-to-day management around the cash flows of these assets, and there's usually a management platform associated in some way. So quite often, the investment in data centers or senior living isn't just a collection of senior living assets, for example. It's a company that manages senior living assets. And so opportunistic funds have more latitude to take slices of holding companies. So it fits under a real estate umbrella, but it doesn't quite fit the definition of what real estate tends to be for most core open-end funds, for example."

Jim Valente, global head of data services at RealFoundations and one of the godfathers of real estate benchmarking, says part of the problem is many industry players are reluctant to contribute to the cost of creating the much-needed transparency that indexes and benchmarks provide. "If you're not contributing your [assets'] performance to either MSCI, NCREIF and/or INREV/ANREV, and you're complaining that there's not enough coverage, then well, an argument could be made that you are part of the problem," he says.

"The other problem is that, in my experience in real estate … everybody wants a free index, a free benchmark. But it's not free, and it can't be free, especially with new regulation and the cost of complying with privacy laws, whether that be GDPR in Europe or CCPA in California. Those are real costs associated with both privacy and ensuring the accuracy of benchmarks that investors use to manage and allocate trillions of dollars of capital into real estate."

Catch-22

One of the issues with producing exclusively niche benchmarks is the immaturity of many niche sectors. Dominated by a handful of players, they create an egg-before-the-chicken dilemma for benchmark providers and investors.

"There's some discussion around having a separate index focusing on logistics in China," explains de Geus. "At first you had one big logistics investor there in the form of GLP; now Blackstone is there and a bunch of others, but you need a minimum of five names and some proper diversification in a sector. Otherwise, you're looking at the performance of one or two participants, which they might not like. And for them, it isn't worth producing freely available and transparent indices. So we need to have some more names, in a market or in a certain sector, before it makes sense."

Robson likens it to a Catch-22 situation. As market participants find ways to invest more in alternatives, they will naturally appear in benchmarks. But there is reluctance in some quarters to take a leap of faith, when they perceive their benchmarks to be completely irrelevant to a self-storage and data center strategy, for example. Robson argues that, if an investor has conviction and wants to invest in a sector because they believe it can improve a portfolio's overall risk-return characteristics, then perhaps that is the path upon which they should embark. "In that case, then, you can see if they outperform your usual benchmarks," he suggests.

"And then just gradually over time, niche areas will be more and more part of the index. It's just like with build-to-rent in the U.K. It wasn't historically part of the institutional asset mix, but it's growing quite quickly now. It's just evolution over time."

Excuse?

Is the lack of specific niche benchmarks a convenient excuse for some investors? Valente at RealFoundations believes it may be.

The former managing director at MSCI chooses single-family rentals in the United States to illustrate his point. The en vogue sector has prompted a flurry of capital raising, but there remain market participants who shy away from the asset class, as it is "not multifamily, doesn't have a benchmark and you can't compare the two."

But that is the equivalent of saying you cannot compare a portfolio of multitenant office buildings with one comprised of single-tenant office assets, argues Valente. Granted, their profiles are somewhat different, but if you hold enough single-tenant office buildings, then it is much like having a portfolio of multitenant office, due to the reduction in single-tenant risk. And even if you only compare two office properties — one single-tenant and the other multi-tenanted, but one of those tenants takes up half of the space in that building — from a risk perspective, is the difference really that pronounced?

"It's not always as big of a difference," Valente argues. "So saying that I need a separate single-family or single-tenant benchmark, or else I can't benchmark my performance because it's a niche, or saying that medical office is so different from traditional office that I can't benchmark it [...] I don't know that I agree with that. If you look at the different factors driving risk profiles across properties, I just don't see that they're always as radically different as investors may want to think they are — and, therefore, they may not require separate benchmarks."

One way to get around the whole problem, in Valente's view, is to adopt a new mindset. This involves placing risk factors ahead of property-type considerations. In other words, factors such as timing, development, volatility, liquidity and income duration should inform performance comparison thinking.

"Hotels can be included in core funds," he says. "But that's exposure to income duration and volatility, right? Hotels have, in effect, daily leases. Or take student housing. It has a similar profile to multifamily, but if you don't deliver your asset in time to lease up for the coming school year, then you're dead for a year. So timing and development risk [play] a huge part."

On the flip side, Valente says an asset class such as medical offices, which has long-term leases and higher renewal rates than traditional offices, is still classified as a niche property type. By assessing assets on a pure risk-factor basis, property labels can almost be discarded, negating an immediate need for specific niche benchmarks.

Investor pressure

Whether investors will choose to switch their thinking in such a manner is an open question, and the conservative tendencies of real estate investors suggest niche benchmarks will remain a point of contention for the foreseeable future.

Given this reality, de Geus says the onus still lies with investors to force through improvement. He admits the ANREV index still has some noticeable holes within the Japanese market. While ANREV is working hard to improve its coverage, a lack of widespread engagement among managers persists as a problem. "I'm always a bit surprised that LPs do not make it obligatory for a manager to provide its performance information to index producer XYZ, if they are deploying capital into their funds," says de Geus.

“It’s not about putting a gun against a head. But everybody’s talking about ESG, and part of proper governance should be the ability to benchmark the performance that you deliver. So if managers are concerned about ESG, they also have the obligation, in my mind, to provide proper governance and transparency by, for example, automatically delivering their returns to an index.”

A game of catch-up

Investor pressure aside, there is an overwhelming sense that benchmark providers will always be playing catch-up when it comes to real estate. As Caruso admits, the industry always moves faster as players look to capture outsized returns when they see them.

Jennifer Stevens, co-founder and managing partner at Alliance Global Advisors, agrees, but stresses the data does actually exist for many niche sectors. It’s about where it exists, who owns it and whether or not the data is reliable.

Sectors such as select-service hospitality, manufactured housing, independent living, assisted living and medical office have existed across multiple cycles and have institutional data reporting that goes back long enough to create a large sample size, says Stevens, who previously worked for The Townsend Group. “Somebody has the data. But do those groups consider their data to be proprietary? And who owns it? And why hasn’t it been released to the industry at large? Those are my main questions.”

Large chunks of fund- and property-level data collected by consultants would serve the industry well by bridging the gap and solving niche-benchmarking challenges. “For the associations to get to the same level of data that the consultants have is a real challenge. You have to have buy-in, and there’s a lot of performance bias and success bias in the numbers in the participants.”

Added to that is the fact there is no uniform method or standard by which to collect and use data for benchmarking purposes. “The responsibility often falls on independent associations like NCREIF and others,” states Stevens. “These groups are advancing reporting standards and collaborating with other associations. I am positive the associations will get there — it’s just a slow hike up the mountain.”

Efforts to introduce universal standards take even more time due to the reliance associations have on volunteers from the investment community. Caruso stresses he and his colleagues are doing their very best, but at the end of the day, they have day jobs that have to take priority. What's more, the associations are now all working on a global scale as they strive to produce better benchmarks, which effort slows progress down even further. He points to the creation of the total global expense ratio (TGER) as being indicative of the plodding nature of global cooperation. The TGER came into effect this year, allowing for a more level playing field in terms of comparing fund costs. It took five years to implement, from conception to execution.

Caruso echoes de Geus' rationale. "How do we make it happen faster, better? It's about getting LPs to the table saying, 'Hey, we should be able to track x or y, and we need that ability to do that. Then that puts pressure on the organizations, like ANREV and NCREIF, to work as the voice of the investor in their best interests. LPs, therefore, need to put pressure on GPs, or at least put it on the radar for some of these organizations, so that they know what their pain points are." Considering such collaboration from a wider viewpoint would also be beneficial, says Caruso, given managers would profit from extensive data sharing, as well, because it would bring standardization and reduce guesswork.

Getting there

There are reasons to be optimistic. Alliance is engaged with industry participants and supports the development of best practices — and advancement as data improves. Stevens points out that industry participants are again discussing the introduction of a common due-diligence questionnaire, which has been widely opposed for some time. If that concept can be reconsidered, it gives hope that similar initiatives will appear in relation to providing fund- and asset-level data.

Technology is playing its part, too. For instance, de Geus says ANREV is investing heavily in IT at the moment, together with INREV, to make the index calculation more efficient.

"We are now 85 percent to 90 percent of the way there," says de Geus. "Fifteen or so years ago, we weren't even 10 percent of the way there. We've made major progress as an industry, and this is only happening through these industry associations where GPs, LPs, consultants and service providers are putting in the work to make the industry more accessible and transparent. And indexes are an incredibly important part of that.

“It’s not like there’s one magic switch that we turn on and the world is going to be perfect in benchmarking real estate. It is just hard work. You’ve got to continue to stay on top of it. You continue to see fund managers disappear, new funds show up, and you have to continuously be out there, motivating and inspiring people to become part of the platform.”

Thankfully, he adds, most people are of that same conviction.

Marek Handzel is editor of *Institutional Real Estate Europe.*