

## CRE Investors 'Tired Of Sitting On Their Hands'

By Georgia Kromrei

*Law360 (September 4, 2024, 12:51 PM EDT)* -- While real estate fundraising has been slow in the first half of 2024, investors are growing weary of waiting, and are keen to put capital toward sectors that have performed well despite high interest rates and changes to how people use real estate, a King & Spalding LLP partner told Law360 Real Estate Authority.

Real estate fundraising is coming off a quiet period for transactions, punctuated by some large deals, and one in which real estate, by some metrics, underwhelmed investors. As the possibility for a rate cut by the Federal Reserve comes into focus, the market is gradually gaining momentum.



John Wilson

Deals are getting done and fundraising is ticking up, but investors are choosy. Amid the current commercial real estate downturn, some asset classes stand above the rest, unaffected by the dramatic changes in how people use office buildings. Multifamily performance — if not valuations — has shown strength this year. Recent large transactions have also bolstered the rental apartment sector.

Data centers have continued to draw investor interest, too. Driven by growing computational requirements of artificial intelligence, a number of large data center joint venture deals have recently closed. The strategy has been especially popular with institutional investors.

John Wilson, a partner at King & Spalding, focuses on the formation of open- and closed-end private investment funds, separately managed accounts and other investment vehicles. Wilson talked with Law360 about data centers, the multifamily market and how institutional investors are "getting tired of sitting on their hands."

The following interview has been edited for length and clarity.

**Values in some asset classes have plunged. Others seem relatively OK. Across all asset classes, they're dealing with high interest rates. Transactions have been slow, and fundraising has, as well. Fundraising has been a little bit slow. Are there signs, from your point of view, that it's picking up? And what is it like right now for fund managers?**

There are signs that it's picking up. And we're starting from a base of the first half of 2024 being the lowest fundraising that we've seen in real estate funds in over a decade. So we're turning from a low point, but during the summer and end of third quarter, we are seeing signs of greater investor interest in investing. Certainly, in 2024 to date, the biggest amount of money has gone into multifamily and industrial, and in that

order. That continues to be, sector-wise, where you're seeing the most interest.

It's for the obvious reason that, despite what the current market is, the demographic trends from both of those sectors continue to be very strong. And so, investors have confidence that those are going to be important sectors to be invested in through cycles.

**Multifamily has always been considered a safe-haven asset, especially value-add multifamily. It's such a time tested strategy. So I'm curious, what is new in value-add multifamily? How are investors thinking about it right now?**

They're expecting there to be a lot of opportunity in value-add multifamily, maybe in the second half of 2024 but certainly going into 2025. Like you said, it's been a consistent area of focus for investors and managers. And we've continued to see managers raise money for multifamily, even through this downturn in fundraising, and we're seeing, you know, increased interest in that now, from some for immediate investing, probably more for 2025 investing.

I think the thought is that we're getting to a turning point where there are going to be more transactions. You've got sellers that have been reluctant to sell, maybe hoping for a better day, but that's been going on for a while. And some are at a point where they just need to sell, and I think there's a general thought in the market that, if you get an interest rate cut in September, that may improve the market enough, and potentially, with more to come, that it'll drive some increased transaction activity.

But I also think that the reason for [the interest in] value-add versus core or core-plus multifamily, is because you've got assets that are perfectly good assets, but they are value-add more because of valuation than they are because of the condition of the real estate.

That's interesting. When I think about typical value-add multifamily, I think about assets that need some investment, to be fixed up, to have some physical things addressed and improved, and then rents adjusted up accordingly. But you're saying that that's not what's going on with these properties.

In this market, there's an additional version of value-add. Eighteen months ago, that asset was core plus. But because of where the valuation is today, relative to where it had been, where the leverage is, and where that seller stands — needing to sell at a lower price than likely they thought they would have sold a year ago — on the buy side, that's a value-add asset, because of what the entry point is going to be.

**I wanted to talk a little bit about regional banks pulling back from commercial real estate. The attention is mostly on the office sector, and there has been more regulatory scrutiny on banks' commercial real estate lending. I'm curious if multifamily is kind of getting — as well as other real estate asset sectors — caught in the dragnet? I don't think multifamily has the structural problems that office has. Does the retreat of a go-to lender, combined with the idea that the fundamentals in multifamily haven't really changed, create an opportunity for non-bank lenders?**

Multifamily, in some ways, is going to be less impacted by the retrenchment by regional banks, just because of having significant [government-sponsored enterprise] money. Freddie Mac and Fannie Mae continue to be significant sources of debt for multifamily. So, we haven't seen that impact as much in multifamily as in other sectors that don't have that government-backed financing. But having said that, yes, in multifamily and in other sectors, certainly, there's an opportunity there for other lenders. We're seeing many of them be alternative lenders, that what's replacing those smaller banks are debt funds. That's one of the areas where there's been another green shoot in the fundraising where there has been a fair bit of already raised debt

fund money and there has been additional money raised around the dynamic you just mentioned. And then, just more generally, the maturity wall that's been written about so widely.

**Do you feel like there is a lot of pent-up energy? Do you think there's going to be a trigger — maybe interest rates — and the dam is going to break, and we'll see a wave of transactions? Or is it going to be more gradual?**

I don't think it's a wave, an immediate shift the moment that a particular event happens, like a rate cut, but I do think that there is pent-up demand on both sides. You have sellers who do need liquidity and who do need to return capital to their capital sources at some point that have been waiting and waiting. At some point, they are going to run out of time. They also may be facing the debt maturity situation.

Then on the fundraising side, you have institutional investors who are becoming under-weighted to real estate. Many of them are maintaining, if not increasing, their target allocations to real estate. They are, to some degree, getting tired of sitting on their hands. They're going to want to put capital to work, and they're looking for places to do that.

So, I think that's where the value-add, and even, in some cases, more opportunistic strategies are attractive, because that may be the best opportunity at this point in the cycle.

**How are investors thinking about AI's impact on data centers? Is there tension between looking at it in the short term and how AI is going to drive actual revenue versus thinking about it as a long-term investment?**

Investors and data center operators are seeing it as a very significant opportunity, just because of the fairly staggering amount of additional data center capability we're going to need to support the projected use of AI. Even before AI reached the level of interest and growth that it has right now, there was a pretty significant opportunity in data centers, and we've only seen that increase over the last couple of years.

What we've seen is that the sophistication and scale of the data centers that are needed is driving the activity to be more with large data center operators, who are then raising capital in more of a JV format, [rather] than some of the traditional real estate fund [managers], who may have some operating capability, but not to the same degree that a large operator does. I think that's driven by the amount of management you need for both to develop and also to operate the type of data center that's needed to meet the current challenge, which includes the needs for AI.

**It seems like there have been a lot of joint venture deals with data centers in the last six months. What are some of the unique considerations when developing data centers, and what kind of expertise is needed?**

Taking the two pieces of the question, part of it is just the sheer scale. Each project is individually very large and so, to start one, you need significant known capital. It's been a real natural fit for larger, institutional investors who want to make a significant allocation to a manager or operator, and that's what's driven those series of JVs that you're talking about that have been publicly announced. We're working on several right now.

What's driving that is that, at that scale, you can have a large JV to do a relatively small number of projects, right? It may be a single project, or it may be two or three, but because of the scale, it's still putting the amount of capital to work that gets an institutional investor interested.

The second half of the question was, what's the expertise needed? It's just much more technical. There are

the basic issues of location and getting appropriate zoning and licensing and then, obviously, dealing with local utilities is a completely different skill set that you need. It's not nearly as relevant to other types of real estate, but in a data center business, it's really the proximity to connectivity combined with having the sheer power to run the data center that are differentiating factors for that asset class. Operators who have that experience are the ones that are able to raise the capital and develop these things.

**I'm fascinated by the aspect of dealing with local utilities. Like you said, that's not really something that comes up super often in real estate. I imagine it will come up more going forward. What are some of the challenges and dynamics at play when dealing with utility companies?**

What you see is simply that it's just a very different player than the typical commercial real estate investor is used to dealing with because they're not as profit-driven. They're not feeling the same imperatives that the typical counterparty is, whether it's a buyer dealing with a seller of typical real estate, or a borrower and a lender. [Utility companies] have a very different mission, which is serving the community that they're in and making sure there's power for everyone in that community, not just that data center.

They're not driven in the same way toward the success of the project, or completing the deal. They're more focused on the broader mission. Then, frankly, it's people who have different skill sets. These are not financial professionals doing large-scale transactions. That's just not what they do. So you're dealing with people with a different skill set, a different focus, and it takes some real recalibration on the part of the manager or the operator to know how to navigate everything I just described. Plus, it's regulated, which, by and large, real estate investors aren't used to.

**Going back to multifamily, it seems like the current administration is very focused on the rental sector. But sometimes it's hard to tell what is something seen as impactful by investors. There was an executive order that focused on tenant screening last year. There's the RealPage lawsuit. There are regulations from Fannie Mae and Freddie Mac that were just implemented. Are there any policy issues that multifamily investors are keeping an eye on right now?**

You just hit on the one we've probably seen the most focus on, which is investors wanting to understand the impact of the RealPage litigation. I think that the lawsuit filed last week was only against RealPage and not the managers is seen as some amount of good news. The managers don't seem to be the target, at least not right now, but there's still significant litigation that needs to be resolved.

The bigger question is, how much does this impact the manager going forward? There's first a question of, is there any liability for, historically, what they've been doing? And then, to what degree was a manager relying on RealPage or similar products, and how will that change? Because it likely will change.

We're hearing from the more sophisticated managers that, in reality, this is not going to change their business significantly. Many of them were using those products to some degree, but they were not heavily reliant on it. If they have to shift away from it, it's just something they'll do. Investors are focused on understanding, from their managers, how big of an issue was this? How much will you have to retool your business, if at all, in response to this?

--Editing by Melissa Treolo.