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Q&A Ranks of Real Estate Secondary Market Still Thin Even as Volume Climbs

Competition for secondhand stakes in private equity-style real estate funds has risen in recent years, according to **Sarah Schwarzschild**, a principal in **Carlyle Group**'s real estate investments division. However, the number of players in the market remains low, compared to direct real estate investment or the secondaries market for buyout funds, she said. Carlyle this year closed its first fund dedicated to real estate secondary and co-investments. Schwarzschild oversees the secondaries portion of the fund's investment. She spoke with Bloomberg Brief's Ainslie Chandler. Her comments have been edited and condensed.

Q: Do you focus on any particular real estate sub-sectors?

A: It's completely opportunistic. We look at every opportunity as it comes in through the door. We see about $10 billion of opportunities every year. Last year it was more than $12 billion. Our fund is a $553 million fund, so we have gotten pretty good at the fast "no."

What we are really looking for are opportunities where we can leverage our competitive edge and buy into properties below their market value. We are discount-agnostic, meaning it doesn't matter to me if the price translates into a discount or premium to NAV. We focus on the major property types in the major, liquid markets because we think that they are more resilient in the downturn. Most of our investments in the last couple of years have been in the U.S. because we are seeing the most interesting opportunities here. That will change over time. We have a global platform. We will navigate where we see the most interesting deals come up.

Q: How much has the volume of real estate secondaries grown since you have been involved in the market?

A: In 2013, the volume was at about $3.7 billion. Last year, between $7 billion and $8 billion of transaction volume closed.

Q: Is that growing at the same rate as primary fundraising?

A: No, much bigger. It's definitely outpaced. And it's for a couple of different reasons. Initially, the catalyst was the financial crisis, which caused sellers to get out of these positions, either because they didn't want to have the unfunded liability or they wanted the near-term liquidity. Then, over time, it really became a widely accepted portfolio management tool, which mirrors what happened in the private equity secondaries sector.

Q: What type of sellers are you seeing?

A: It has varied over time. During the crisis, the first sellers were endowments and foundations because those organizations tend to be nimble and had to fund their operating budgets. Then, the wave of regulations came through and there were a lot of financial institutions and banks selling. In the last couple of years, it's been more opportunistic. A lot of institutions are using it to rebalance their portfolios and some investors are deciding to get out of investing in funds and will invest directly instead. Now, what I am seeing this year versus last year, is there is a change in sentiment because they believe real estate is late in the cycle.

Q: How do you feel about that outlook? Does that affect your investment decisions?

A: I sit on the investment committee and we have extensive conversations about that question. We do a lot of research, and we have varying opinions. It makes me be more cautious in my underwriting. I don't believe that we are going to go into a recession like we did in 2008. But, I also don't believe that real estate valuations will continue to increase indefinitely. So, we are taking that into account. We never underwrite capitalization rate compression, anyway.

Q: Are you seeing more competition for secondaries deals?

A: The market is more competitive than it was five years ago but it still remains an inefficient market. A "competitive" process on the secondaries side might have six to 10 players, versus an auction process for a property or on the private equity side, where you could have 30 players lining up. We are seeing increased volume on the selling side and some of the deals last year didn't get done. That tells me that either the seller had really optimistic pricing expectations or there is not enough buying power. There is only so much that the market can digest.

Q: Do you buy many tail-end funds?

A: We do. We like that. Not only because of the risk-return profile of that kind of deal but also because the duration is fairly short. When we look out at what's happening in the broader real estate fundamentals, the macro-economic view, we like the idea that we are taking money off the table in the short term.

Q: Is there anything that worries you about the market at the moment?

A: Just like every other real estate investor, we think about where we are in the cycle all the time. We think about what will happen if interest rates go up. We think about what will happen if interest rates stay down forever. Increasingly, that's looking like a real possibility — that there will be low interest rates for a long time. How will that impact the capital markets versus the fundamentals in the real estate market?

AT A GLANCE

Age: 35

Based in: New York **Hometown**: Boston

Education: B.A. (summa cum laude) from the University of Pennsylvania and an M.B.A. with honors from the Tuck School of Business at Dartmouth.

Hobbies/favorite pastimes: Reading, skiing and spending time with my kids

Favorite sports team: "I'm from Boston so it has to be the Red Sox."