The denominator effect

An excuse for all seasons

by Roy Schneiderman

The denominator effect. Just say those words, and people's heads will knowingly nod in assent. You don't need to explain. Everyone knows. Those problems in the stock market (and sometimes the bond, or other markets) have spilled over into our real estate world and mucked things up — again.

But how much is the denominator effect truly responsible for the current real estate market capital malaise (to put it mildly)? While the denominator effect certainly was one cause of the current real estate liquidity crunch, its impact was fairly short-lived. Yet, it has served to mask other causes of the investment capital shortage — several of which do not have the superficially satisfying characteristic of originating outside our industry.

Let's start with a look at the denominator effect itself. In its simplest terms, if real estate values stay flat while other asset values decline, then real estate as a percentage of an institution's total investment portfolio goes up simply because the denominator in that calculation goes down. Thus, if an institution was at its desired allocation to real estate before a decline, then it is at a higher percentage allocation after a decline in non–real estate assets. So, at best, the brakes are put on new investments, and at worst, real estate groups are asked to sell assets to get back to the desired allocation.

Here is a simple example: Say real estate represents 10 percent of an institution's portfolio "before," and that 10 percent also was real estate's target allocation, perhaps with a 100 basis point buffer in either direction. If the other 90 percent of assets decline in value by 15 percent, then "after," real estate would represent 11.6 percent of the portfolio.

"Gee," one might naively say, "a 15 percent decline in all non–real estate value is pretty draconian, and what about 'appraisal lag'? Won't real estate values likely drift downward over time, at least partially mitigating this effect?" Yes, and yes. Furthermore, is a temporary increase from a desired real estate 10 percent target allocation to 11.6 percent really so significant as to cause a substantial decline in capital available to real estate? CIOs are pretty smart folks who understand market fundamentals and market cyclicality, so it is likely that the CIO's office might react to "the denominator effect" but would not likely overreact.

When did the denominator effect start, and how dramatic has its impact been? We will use the prior 10 years for context and make the significant oversimplification that the S&P 500 Index can reasonably represent "everything else" — at least directionally. In six of the eight years leading up to 2022, the S&P 500 Index outperformed the NCREIF NPI, beating NPI quite handily in most of those years.

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So, in the oversimplified world where there were only stocks and real estate, it was actually stocks that were experiencing a denominator effect from 2014 through 2022 while real estate was actually benefiting from it. This trend briefly reversed during 2022 when the S&P 500 Index declined by 18 percent, and the NPI increased by 5.5 percent (this NPI figure represents total return; appreciation return was 1.6 percent). Thus, there was a denominator effect for real estate in 2022, but it began to reverse (at least S&P 500 versus NPI) as early as the last quarter of 2022, and the overall negative effect in 2022 was more than fully reversed in 2023 with S&P 500 gains of 26.3 percent versus NPI total returns of minus 7.9 percent (and appreciation return at minus 11.8 percent).

The current liquidity issues in the real estate market cannot be solely attributed to the impact of the 2022 denominator effect. There must be more going on, and indeed, there is.

Existing assets are requiring more capital than planned

There are myriad reasons why already-owned value-added, opportunistic and development assets are requiring more capital than was originally budgeted. And this need for increased capital for already-owned assets is diverting capital from new acquisitions and/or new capital commitments.

For example, development and redevelopment costs have increased significantly above what pre-2022 business plans would have projected. Most, if not all, of this additional cost will need to be funded by increases in equity.

Similarly, most pre-2022 business plans would not have anticipated current interest rates. Higher interest rates reduce loan proceeds through the application of higher debt service coverage rates than originally underwritten being applied to originally projected net operating income (NOI). In addition, many assets now have lower than originally projected NOI due to operating cost inflation — particularly insurance in some locations — and lower rents in some property types and some locations. Lenders have also lowered their loan-to-value advance rates. All these factors result in lower refinancing proceeds and the need for additional equity compared with original business plans.

Even with respect to well-performing core assets, full refinancing of maturing debt has become challenging in today's environment due to a) the higher interest rates and lower loan LTVs previously mentioned, b) office properties being particularly out of favor, c) bank lenders having their own significant liquidity issues, d) the high volume of borrowers exercising their contractual extension rights, and e) lenders waiving covenants and/or granting maturity extensions beyond the final contractual maturity date. (These last two factors affect all borrowers, not only core borrowers.) Again, real estate capital for new investment is being diverted to existing assets.

Liquidity begets liquidity

In addition to existing assets requiring more equity capital than business plans anticipated, many investors are also finding the amount of capital being returned is less than anticipated and taking longer to receive for various reasons.

Again, the problem starts with business plans being extended, particularly for value-added, opportunistic and development assets. Then, once asset business plans are completed, managers find "now is not a particularly good time to sell," choosing to hold onto assets and wait for more appealing market conditions. So, investors are not getting back the capital they thought would be available for reinvestment.

Furthermore, some such assets are in closed-end funds, which also have other assets requiring more equity. Thus, capital that might have been repatriated in a more normal market is instead retained in case other assets still in "business plan execution" mode turn out to need additional capital.

These factors lead to reduced capital being returned to investors, which lowers capital available for reinvestment in new value-add, opportunistic and development assets or for commitment to new closed-end funds. They also lead to increased requests for term extensions and manager-led recapitalizations. The manager-led recaps can provide some liquidity for the original investors, but such recaps also often generate very well-produced pitch books explaining to the original investors, "while we are offering you the option to exit and receive some cash, we really, really, really think you will do better if you roll your capital into our continuation vehicle."

Open-end funds are experiencing similar phenomena. Asset exits are being delayed, and what capital is internally generated from sales has often been diverted to investor redemption requests and existing assets that need more equity than originally anticipated.

Internal investor considerations

Finally, internal factors are at play, with some investors currently constricting capital allocated to real estate. Some of these are mentioned below:

First, over the past decade-plus, there has been a general trend toward increasing allocations to private market assets at the expense of public market assets. This trend appears to be plateauing and perhaps slightly reversing. But at least at present, private asset classes are no longer receiving a "bigger piece of a rapidly growing pie." Rather, they are, at best, receiving a similar-sized piece of a moderately growing pie.

Second, there has been a general increase in the array of institutional private asset classes. What had previously been the province of just real estate and private equity is now expanding to include growing infrastructure allocations, traditional sectors such as agriculture and forestry, and current darling private debt, which has garnered significant commitments in the last few years.

Finally, "appraisal lag" creates an interesting dynamic internally. The conventional wisdom is real estate indices/benchmarks are likely to decline in 2024. Thus, from some perspectives, it could look like any new investment in real estate is likely to "lose money" in the short term. Compare that to fixed-income investments, where the conventional wisdom is rates will come down this year, and whether it is a slow, gradual decline or a fast, steep decline, fixed-income investments should do well. This seems to present an easy choice.

I disagree, of course. But I am biased. ❖

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