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Multifamily, Industrial Remain Top Choices for Institutional Investors

Institutional investors remain committed to the best-performing sectors, although there is some interest in newer subsectors, according to exclusive WMRE research.

Results from the 2023 *WMRE* Institutional Investor Survey (brought to you by AppFolio) show that multifamily and industrial remain the favored property types.

Respondents said institutions are most likely to prefer investing in multifamily (60%) and industrial (50%), followed by life sciences/biotech (43%), medical office (38%) and self storage (38%). Those sectors that were viewed least favorably included retail (19%), hotel (18%) and office (17%).

Multifamily remains firmly entrenched as the most popular sector for a variety of reasons. Multifamily has historically been number one or number two in terms of generating the highest returns. So, it's that historical performance, the ability to mark leases to market rents every year and the overall shortage of homes that continues to drive demand for multifamily, said David Reynolds, president of investment management at Mill Creek Residential, a developer, owner-operator and investment manager specializing in rental residential properties. "We expect the residential rental sector to perform well in the coming years because of the shortage of homes and because of the decreasing affordability of homeownership," he said.

Multifamily has also become a more nuanced strategy. Institutions are taking a more granular approach to residential strategies that dig into price point, location and property type across core, value add and new development, said Reynolds. "We're

especially seeing more of an interest in what we call attainable or more affordable multifamily product," he said.

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In addition, institutions are expanding their residential strategies to include more niche sectors, such as single-family rentals, student housing and seniors housing. Last year, Mill Creek Residential raised $1.2 billion in equity across multifamily development, build-to-rent single family and value-add acquisitions. "We're seeing interest in all of those areas, and investors are viewing it as an attractive time to get into the market," he said.

It is no surprise that sentiment on office continues to slide. "Most investors have dialed down their focus on office for some time," said Doug Weill, founder and co-managing partner of Hodes Weill & Associates, a global capital advisory firm. Over the past five to 10 years, institutions have come to realize that office is a very capital-intensive strategy due to the cost of re-tenanting buildings and renovating space, which really cuts into profit margins.

Institutions have reweighted their portfolios towards multifamily, industrial, self storage, data centers and other kinds of niche strategies, and those strategies continue to have very favorable operating fundamentals and tailwinds that are driving the positive returns that we continue to see in the market, he said.

Unfortunately, there is a bit of a herd mentality in real estate, adds Spencer. "Right now office is the asset class you don't want to touch. Lenders don't even want to hear about it, and that's a bit nonsensical," said Craig Spencer, CEO of the Arden Group, a commercial real estate fund manager and operator. According to Spencer, trophy office assets in most of the top markets have either been matching or outperforming compared to pre-pandemic levels, because of the flight to quality. "If you're looking at very high-

quality office buildings in dynamic markets [they] are having record occupancy and record rents. You can't paint that with the same brush as a B quality office building in a poor location that is losing tenants every other month," he says. However, there is a clear shift in strategy that is affecting allocations within real estate portfolios. Many institutions are reducing their exposure to office, while increasing allocations to industrial, multifamily and other alternative sectors, he adds.

Capital tilts towards direct deals

Respondents believe institutional investors are most interested in direct investment in multitenant commercial and multifamily real estate assets. On a scale of 1 to 5, direct investment in multitenant properties rated a 3.2, followed closely by private equity real estate funds and private debt funds, each at 3.1. Despite the recent performance of public REITs, the asset type scored relatively favorably at 3.0. Sentiment on non-traded REITs and CMBS were the least favorable at 2.6 and 2.5, respectively.

"I do think the trend towards direct vehicles is real and the largest institutions are trying to both control their destiny and have decision-making rights, but also lower the cost of portfolio management by bringing some of their portfolio investments in-house," Weill said. That being said, almost all institutions are looking at commingled closed and open-ended funds as a way to deploy capital, he said. According to the Institutional Real Estate Allocations Monitor, published by Hodes Weill & Associates and Cornell's Baker Program in Real Estate, approximately 90% of institutions expect to allocate future investments to third-party managers.

The interest in direct deals likely also includes joint venture structures. "We're seeing a lot of institutions going into joint ventures," said Mike Sebastian, industry principal and director of investment management, at AppFolio Inc., a firm that provides software, services, and data analytics to the real estate industry. Some institutions like having more control and more recourse compared to going into a fund or other structure, and

they also get a lot more insight into the asset-level data on those deals. Although institutions may bring the majority of the capital, they are going into deals with a partner that has specific expertise to manage the deal, he adds.