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FEATURES

DEPARTMENTS

The Paradox of Choice

Large, Diverse Universe of Funds Presents Investors with a Daunting Decision-Making Process

by Denise DeChaine

The private equity fund-raising market is characterized by limited capital availability and an abundance of investment vehicles in the market, a classic case of a supply and demand imbalance. Investors must sort through the offerings, narrow down their options and then select the investment that they believe best matches their objective and strategy. How do LPs go about this winnowing process, and what determines the winners and losers?

"As many more individuals of each species are born than can possibly survive; and as, consequently, there is a frequently recurring struggle for existence, it follows that any being, if it vary however slightly in any manner profitable to itself, under the complex and sometimes varying conditions of life, will have a better chance of surviving, and thus be naturally selected."

While Charles Darwin was referring to living beings on Earth, the concept also could be applied to today's evolving universe of real estate investment managers and investment products. In the end, it will be survival of the fittest; those managers that can't attract capital in today's challenging fund-raising environment will perish.

With hundreds of funds currently in the global marketplace seeking capital, how do investors and consultants sort through the morass of offerings?

"It is not an easy process," says Susan Swindell Carter, director of real estate investments for the North Carolina Retirement Systems (NCRS). "I would say it begins with our existing portfolio and the needs within our portfolio."

THE PROCESS

Making a decision on a specific item is always a choice between one thing and another thing or one thing and a number of other things. It can be an easy decision, such as choosing what to have for dinner, or a tougher decision, such as what to name your child or which house to buy.

The same goes for deciding on which fund to invest in. Investors and their consultants have to make a decision that will profit their clients or beneficiaries. To ensure the best results requires a time-consuming process and effort by many people.

"This is a challenge that we face head on with our portfolio; our consultant, The Townsend Group, tells us they are aware of over 500 private real estate funds that are currently seeking capital from institutional investors," says William Estabrook, executive director at Ohio Police & Fire Pension Fund. "As a starting point, Townsend and staff look at our portfolio construction needs and couple it with a top-down view of what strategies they believe will be the most attractive in the market today. Our consultant meets with the majority of the managers raising capital and provides us with a short list of prospects that fit our particular objectives and our current portfolio. Our staff also screens opportunities carefully."

With a multitude of fund offerings to review and consider, the required due diligence can be daunting. Joy Winterfield, portfolio manager at Allstate Investments, explains the typical approach the organization employs.

"We typically begin by evaluating the entire universe of potential managers, and then filtering this list down to those managers targeting strategies that line up with our client's desired exposure," says Winterfield. "We then schedule introductory calls or meetings with those managers who met our initial filters in order to better understand their backgrounds, industry views and track record within the targeted strategy. Then we request each potential manager to complete our internal due diligence questionnaire, which provides significant asset-level detail and improves our understanding of their capabilities in executing a particular strategy. We round out our review through a series of calls, in-person meetings and asset tours, further narrowing our list down to a select number of managers that we feel are appropriately aligned with investors and have a proven ability in the stated criteria. We place significant importance on 'case studies' of specific transactions to build our understanding."

The process for a consultant is similar as they go through the vetting process for their clients. Allison Yager, principal, global business, and investment leader at Mercer, explains, "Our first step is to ask each manager to provide some high level information on their firm and strategy to ensure that the strategy matches with our current outlook for attractive investing opportunities and our client's needs. We also have a global, Internet-based database that we use to track all available offerings. If we review an offering that we believe is appropriate given our market outlook or that fits a client's need, we will hold a call or a short meeting with the manager at our office to conduct an initial discussion and then proceed to an on-site, detailed due diligence meeting if the opportunity warrants such. It is a difficult process for the manager to go through, but our clients put their trust in us to cull the number of offerings down to a manageable level, and we take this process very seriously."

NARROWING THE CHOICES

The size of the plan sponsor and its dedicated real estate staff can affect its menu of investment options. The North Carolina Retirement Systems has assets of just under $72 billion with a $5.14 billion real estate portfolio, representing 7.15 percent of the total portfolio. Its policy target for the real estate asset class is 8.0 percent. This percentage helps NCRS have a diversified outlook on what to invest in, but some limitations arise due to state limitations and staffing constraints.

"The real estate portfolio is broadly diversified with investments across not only the core real estate sectors but also noncore sectors, such as senior and student housing, self-storage, and net lease," says Swindell Carter. "State statutes and a small staff relative to other plans of our size prohibit us from investing directly, so all investments are made through investment managers. We invest through separate accounts, open- and closed-end funds and public REITs. All investments are structured as LLCs, LPAs or REITs."

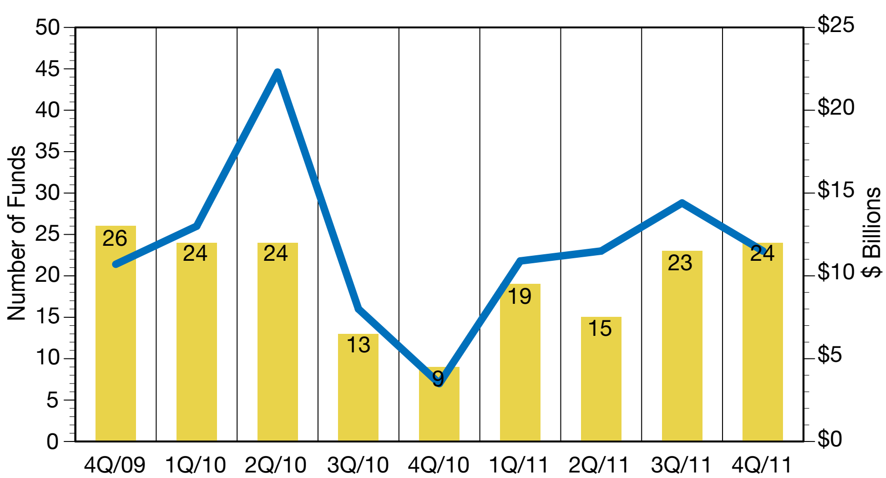
At Allstate Investments, which manages a real estate equity portfolio of approximately $2.5 billion, including $1.8 billion of which is allocated to real estate funds, the group seeks diversification across property types, geographic regions and strategies.

"Our real estate equity exposure consists of direct co-investments alongside our fund managers, joint ventures, separate accounts, tax credits and a socially responsible investing portfolio," says Winterfield. "The majority of our existing fund exposure is allocated to opportunistic strategies, and we are currently focused on, one, building our core exposure domestically through direct equity investments and, two, growing our international portfolio through selective commitments to local fund operators."

Estabrook at Ohio Police & Fire explains the retirement system uses its real estate portfolio for traditional purposes.

"We use our real estate portfolio for traditional purposes: to diversify our broader portfolio, in pursuit of attractive risk-adjusted returns and as a partial hedge against inflation," says Estabrook. "To accomplish this, we target a portfolio that is about half core and half noncore. This mix fluctuates over time based on our view of the market."

Fund-raising Trends — 4Q/09–4Q/11



Source: Institutional Real Estate, Inc.

SIZE MATTERS

While fund offerings range a broad spectrum of size and strategy, well-established seasoned opportunity fund managers with their mega-fund offerings seem to have a leg up on the competition. Post–global financial crisis, many investors have been steering their money to veteran investors with proven track records, such as The Blackstone Group. The behemoth private equity firm is currently in the market with its Blackstone Real Estate Partners VII, which has a $10 billion fund-raising target and has raised more than $6 billion to date.

The competition for limited institutional capital could get even more intense. Other managers that have multibillion-dollar high-yield funds in the market or in the planning stages include Angelo, Gordon & Co. (target of $1.25 billion), Brookfield Asset Management ($3.5 billion), Cerberus Real Estate Capital Management ($2 billion), Colony Capital ($1 billion), Fortress Investment Group ($1 billion), Rockpoint Group ($2.5 billion), Starwood Capital Group ($3 billion), Walton Street Capital ($2 billion) and Westbrook Partners ($2 billion).

Last year's fund-raising totals offer a perfect example of the advantage enjoyed by this group of managers. During 2011, 81 private equity real estate funds announced final closings, raising an aggregate $48.3 billion; the two largest funds to close in 2011 were both sponsored by Lone Star Funds and their cumulative capital haul of $10.1 billion represented 21 percent of the total equity raised during the year. In addition, the top five largest funds accounted for a third of the total capital raised in 2011.

"Some funds are raising large amounts of capital because they have strategies that are particularly relevant in the environment; have competitive track records; have intact teams with organizational resources to implement their strategies institutional processes, documentation and reporting; and have a track record of raising capital and getting funds over the finish line to first and subsequent closes," says Sally Haskins, senior vice president at Callan Associates.

Obviously, smaller emerging managers have their work cut out for them (see "Can Emerging Managers Compete for Institutional Capital?", page 14). However, Haskins advises investors not to discount the smaller and mid-sized investment managers.

"Small and mid-sized managers are relevant," says Haskins. "Those funds often offer investors very targeted strategies that can fill a specific role in the portfolio, and investors may be able to shape the strategy and the terms to their preferences. In many portfolios there is a role for both.

"The relevance of large versus small is not really the question," adds Haskins. "The question really is does the strategy make sense in the environment? Does the organization's skill set match the strategy? Are they equipped to handle institutional capital? Have they delivered for investors in the past? Does the structure match the strategy, and is it competitive relative to market norms and institutional expectations? And importantly, does the strategy fit in the investor's portfolio, and is it an efficient way to invest?"

DIFFERENT STOKES

What are investors and consultants looking for that may sway their decision?

One item that is always front and center for every investor: fees and terms. Fees and terms can make or break investing in a fund, especially depending on the size of the investor.

"Fees and terms make a difference on the margin," says Haskins. "They don't make a bad fund good or a good fund bad. Everything is negotiable, although we don't negotiate the same things on every fund. The type of organization offering the fund, the fund's strategy and the fund's structure, including the fees and terms, need to line up. Client preferences on fees/terms obviously factor into the equation."

"Fees are important, but certain terms can be even more important," adds Yager. "The fund should be structured to provide certain rights and protections for the investor and incentives for the manager to remain committed to the strategy."

How to go about choosing a fund, and what to invest in is always changing. For each plan sponsor, the decisions are relevant to their existing portfolio composition and their current strategies.

Swindell Carter explained that NCRS was primarily focused on investments in debt last year.

"We compiled information on over 75 managers, met with approximately one-third of them, had second interviews with 12, selected eight for due diligence and closed — or will be closing soon — on six managers," says Swindell Carter. "Each manager has separate and distinct strategies, ranging from origination to distress and loan-to-own strategies, and everything in between."

Swindell Carter explains that 2012, though, will be the year of portfolio analysis and relationships with existing managers.

"We are studying various vendors who can provide data services specifically for real estate and use these services to better track and analyze our portfolio," says Swindell Carter. "The data will then be applied to a larger total plan project that strives to measure total plan risk on a current basis. Our investment pace this year will be slower than years past. In addition, we are working on completing a large platform investment in the multifamily space."

Others, such as Allstate Investments, will be looking toward higher yielding investment opportunities in emerging markets.

"The last two years have been rather exciting for us as we have significantly expanded our fund portfolio into developing markets," notes Winterfield. "We began in Brazil and instituted a replicable diligence process that we were able to carry over to India as well. Our network and contacts allowed us to evaluate the universe of institutional managers in each market, and narrow our search down to the best-in-class operators within our desired strategies in each market.

"We also recently completed an evaluation of the U.S. core open-end fund universe, and plan to revisit diligence on local operators in Asia, and local managers targeting distressed investment strategies in Europe later this year," adds Winterfield.

Asia, with its appealing demographics and economic growth stories, is generating growing interest among investors, and the fund universe focused on that region has expanded greatly in recent years.

"I track Asia specifically, and there are over 20 direct offerings and a few fund of funds offerings in the market with at least another five directs coming to market in the next six months to 12 months," states Haskins. "Most of these are noncore. This is the most robust universe of Asian funds since 2006–2007."

WHERE TO FROM HERE?

So, what are consultants advising?

"We have advised clients to focus on both core and higher-yielding opportunities, assuming they have the risk tolerance," says Yager. "We feel that at this point in the market cycle, investors should selectively move up the risk spectrum to take advantage of certain higher yielding opportunities that we believe are attractive given where we are in the market cycle."

While the fund selection process may be slightly different for each investor, it involves a detailed, thorough analysis. The goal is to find the best match for an investor's goals and strategy. Track record and management team experience and expertise are emphasized. While large investment managers may possess an advantage, in the end, it's not the size of the manager or fund that sways the decision; it's what makes sense for the investor. ❖

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Can Emerging Managers Compete for Institutional Capital?

by Nancy Lashine

With more than 700 funds currently in the market, raising capital is certainly harder for emerging managers than it used to be. Before the market crash, private real estate operators had access to both inexpensive debt and private real estate equity raised by allocators to partner with local operating firms. The allocator capital, in particular, provided a clear path for local operating partners to gain an institutional track record and credibility, on a deal-by-deal basis. For many operators, this was the successful first step in becoming an investment management firm.

That all changed in 2008, when the music stopped on the debt side and the private equity fund-raising machine ground to a halt. As available capital fell, so did prices, compounded by deteriorating fundamentals. Capital began to trickle back to real estate in 2010, transaction volumes increased modestly and fund raising started to pick up again, albeit significantly below peak levels.

The critical factor has been the decline in the popularity of the large allocator fund model, which means that emerging real estate managers are competing for scarce institutional capital with their peers as well as with experienced investment teams. Further, smaller operators generally have less access to attractive bank financing in this market, and with lower leverage ratios, will need more equity for their deals.

Does that mean that emerging managers can't compete in today's marketplace? No. It just means they need to adapt.

Here are the essential steps needed:

- **First, managers need to demonstrate credibility by building out an institutional infrastructure ahead of the commitments of capital.** Investors will certainly look at the stated strategy and whether it is supported by an historic track record, the organization and realized performance through cycles. However, the real estate acquisition and asset management skills of the team need to be supplemented from the start by strong reporting, accounting, compliance and finance capabilities.
- **Second, emerging managers would be well served to be honest with themselves on their commitment to a longer investment cycle and the reality that fund investors are never the cheapest source of capital for Fund I transactions.** When investing fund equity rather than deal equity, real estate investors make a major shift in the business plan and the basic math of their business. Instead of earning an incentive on a deal, now the incentive is earned across a fund, and the capital and profits hurdle are pooled and returned to investors before any incentive fee is returned. That usually pushes out the moment of financial reward multiple years. So before GPs start raising capital, they should show their business plan to someone with an existing institutional business and ask if it is realistic. They should stare at the numbers for a while because they will have to live with this business for a decade or more.
- **Third, emerging managers should be prepared to demonstrate that they are "relationship builders" capable of taking a long-term view.** Institutional investors want to underwrite relationships for multiple funds. They can "read your lips" and can hear the subtleties between what one says and what one means. Having just survived the 2008 collapse, investors are sensitized to the knowledge that you only learn someone's true stripes when the going gets tough.

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