Cycles, Concentration and Rebirth in the Real Estate Investment Management Industry

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Introduction

Investors today are faced with challenges resulting from the continued concentration in the investment management industry, limited choices of investment managers available to investors and behavioral changes of investment managers over time. Conditions resulting from the recent real estate market downturn make it difficult for investors to establish relationships with new managers (i.e. groups that are new or recently formed investment firms, either start-ups or operator/developers that are entering the investment management space). Simultaneously, it is an opportune time in the cycle for investors to be working with those firms which are entrepreneurial, focused and able to nimbly take advantage of investment opportunities.

Many institutional investors have limited resources even in strong economies, but today's budgetary constraints and investment losses have put further limitations on their ability to apply the resources needed to evolve their portfolios. These resource limitations are particularly difficult as investors' portfolios have grown in size and complexity over the years. Many investors are spending valuable time and resources managing legacy issues, thereby making it difficult for them to find, incubate and manage the risks of the new relationships that can lead to broader access to the real estate markets and enhanced deal flow.

It is particularly important for investors to position their portfolios at or near the bottom of a cycle to take advantage of the next cycle, and one of the ways to do so is to build new relationships. The benefits of doing so can be substantial. For example, ten of the firms ranked in the top 15 real estate investment managers (by amount of capital raised) by PERE in May 2011 started or launched their commercial real estate fund businesses during the period between 1991 and 1997.[1] For most of these firms, their first funds were relatively small (i.e., a few hundred million dollars) and were created to take advantage of opportunities arising from dislocations in the real estate and capital markets.

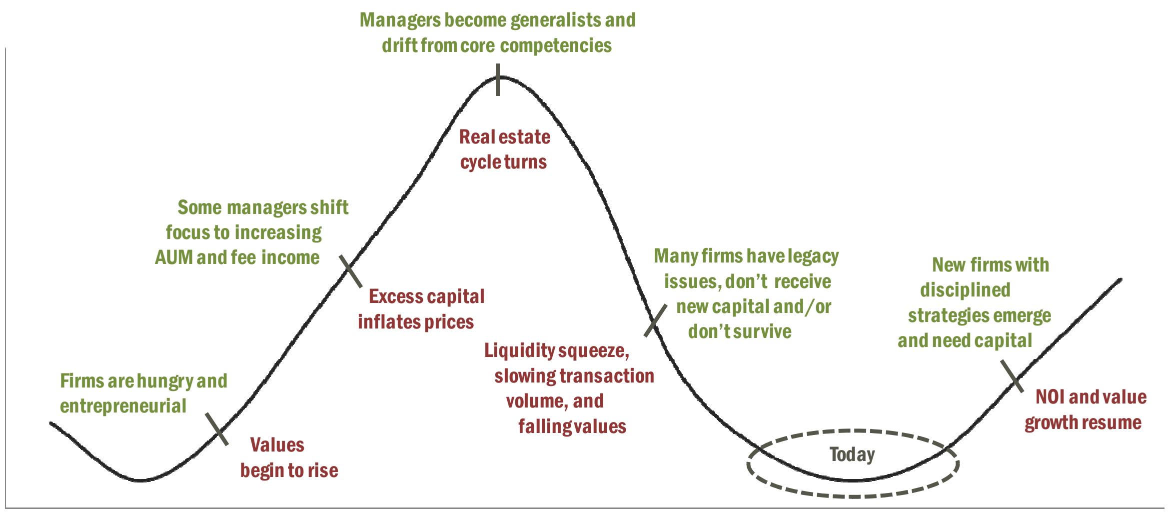
Cycles and Consolidation in the Real Estate Investment Management Industry

Cycles in the investment management industry are related to the broader real estate cycle and work to limit the number of options available to investors over time. Choices become limited due to high barriers to entry for new managers. These market forces can change the approach taken by investment managers, which can result in challenges for investors.

[1] Data is from PERE30: "PERE's Ranking of the 30 Largest Private Equity Real Estate Firms in the World", *Private Equity Real Estate News*, May 2011 and from Hawkeye's review of the websites of each of the top 15 firms identified within the report.

The real estate investment industry has consistently had high barriers to entry for new firms. Factors presenting formidable hurdles to a first institutional capital raise for new entrants include the need for: (i) a track record of managing institutional capital on a discretionary basis; (ii) fiduciary-like practices; (iii) industry contacts and consultant relationships; and (iv) sufficient working and co-investment capital. Institutional investors are often unwilling or unable to take on difficult to manage risks associated with firms new to institutional investment management. During certain points in the cycle, particularly at or near the bottom, there may be more new firms pursuing entry into the business. However, only a few of these new firms are successful in the long run.

Figure 1. Real Estate Cycles and Investment Management Cycles



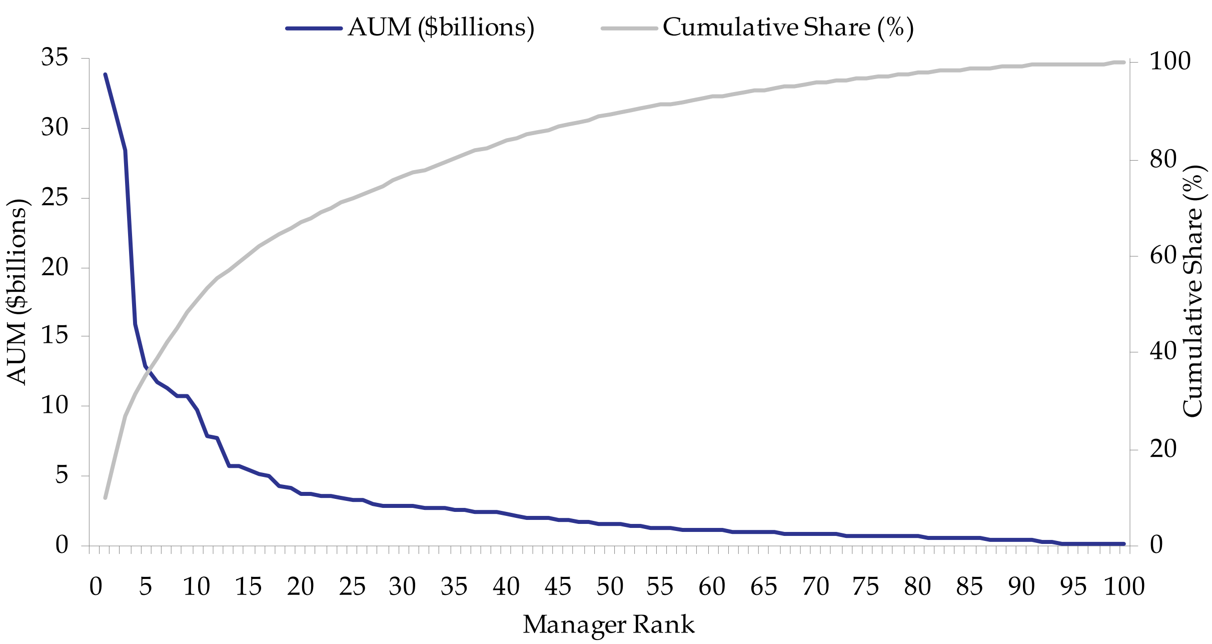
There are several reasons why investor choices are limited during the cycle, which can be seen in Figure 1. During rising markets, due to the actions of both managers and investors, investor dollars can get concentrated into fewer hands. Some investment managers focus on growth in assets under management, either through mergers and acquisitions or by offering more products to broaden their investment platforms. During the most recent cycle, capital poured into large publicly-traded financial institutions and opportunity funds with global reach and ties to private equity as investors sought greater exposure to international markets and other alternative investments. These types of firms were also effective in attracting substantial amounts of investment capital from non-traditional sources, such as high net worth individuals and retail investors. Further, investors often make increasingly larger allocations of investment capital to existing managers in an effort to focus on fewer relationships, thereby creating "concentration by choice."

In a down cycle, investor choices become even more limited as capital is consolidated among firms that do not have significant legacy issues. As property values fall, investors work to negotiate lower fees as assets under management simultaneously shrink. Managers may spend significant amounts of time and effort working to unwind or restructure a large number of operating partner relationships. Those with a disproportionate exposure to higher risk investments experience a significant reduction or elimination of profits and, in the most recent cycle, losses of capital. A firm with legacy issues may be unable to raise new capital which could result in the firm going out of business or being acquired by a competitor.

Some investors will not commit additional capital to certain investment managers for various reasons. Some firms will be merged, sold or may even enter bankruptcy. Other managers may survive, but will not receive new capital commitments until issues with their existing investments are resolved. In many cases, investment managers will lose key personnel because these issues can take years to resolve and compensation in the form of profit participation may never be achieved. Investment managers who were overly exposed to high-risk investments, or had numerous complex relationships, will spend a significant amount of time working out the existing assets in their portfolios. During this time, firm resources may be diverted away from opportunities to make new investments.

The investment management industry is highly concentrated today, as shown in Figure 2. In the *Pensions & Investments* 2010 list of the largest real estate managers of U.S. tax-exempt investors capital, the ten largest managers controlled 48% of the total assets under management and the top 25 controlled 73% of the total assets under management. The rankings from 2005 through 2009 show similar results, demonstrating that the concentration persists through both rising and falling markets, although the particular managers comprising the top 25 has changed over time.

Figure 2. Largest Real Estate Managers Ranked by 2010 Total AUM



Source: Hawkeye, using data from Pensions & Investments, "Real Estate Investment Managers Directory," October 3, 2011.

Certain factors impact investors as managers grow in size. The level and nature of opportunities available to investors and the costs and risks investors assume change in several ways. First, when an investment manager grows to a certain size, the management fees may reach a point where they are large enough that the manager may have an incentive to continue to grow assets under management and less incentive to sell assets, creating the potential to compromise profitability of investments and therefore the returns to investors. Second, size can change a manager's approach to investing. As an investment company's capital base increases, its ability to invest capital efficiently in scale becomes critical. This may result in a reliance on the brokerage community and other financial intermediaries to source investments, a limited ability to pursue middle market opportunities and/or potential difficulty in managing multiple operating partner relationships. Finally, investment managers often move away from their core competencies and stretch their resources as they broaden their array of products to expand their platforms. During cyclical downturns, managers who stretched their resources retrench from their non-core businesses, which often are those that are in most need of management's attention.

Opportunities and Risks with New Managers

There are benefits that can come with investing with new managers, and there are specific and unique risks as well. Institutional investors may have concerns about investing with new and recently formed real estate investment managers, and may perceive the risk of investing with a new firm or in a first time fund as being greater than investing with an established manager or in a follow-on fund.

In terms of potential benefits, while they are not found with all new manager groups, some new groups can offer certain attributes that should lead to greater investment success. These attributes include the following:

- *Better execution.* New managers tend to be specialists (e.g., focusing on one property type or a few select markets) and can more thoroughly and carefully underwrite their investments than large firms (i.e., they do not do "desk-top underwriting").
- *Enhanced access to deal flow.* Specialist managers (i.e., those with targeted and thematic investment strategies) often have unique access to deal flow because of the relationships they have developed. This allows them to source off-market opportunities. In addition, newly established firms tend to be more proactive in their deal sourcing and often uncover unique opportunities.
- *More focused strategies.* New managers tend to be more specialized and focused on their core competencies and targeted investment strategies than large, established managers with broader mandates.
- *Historically successful talent.* Some newly created firms are started by senior executives who have a strong historical track record and who are in a position to start their own firm. The principals of new managers often have their own capital invested in their firm and their "name is on the door." As a result, they have more to lose from both a professional image and economic standpoint than a senior executive at a well established manager.
- *Entrepreneurial framework / better alignment.* New managers tend to be entrepreneurial and more focused on the profits that can be made from real estate investing than the profits that can be made from investment management fees. This results in a longer-term alignment of interest between the managers and investors. In addition, at newly created firms, compensation for the senior executives is usually heavily tilted towards profits from investments and not from fees.

As discussed above, there are risks that come with investing with new managers. These are typically barriers to institutional investors' desire for investment with new groups, as they represent unique risks that come with investing with new managers. They include:

- *Lack of a discretionary track record.* New managers, almost by definition, do not have a track record (with their current firm, at least) to demonstrate investment success. Some groups may have been working as operating partners, without investment discretion. Other groups may have a personal discretionary track record, but with a larger firm.

- *Concerns about deal flow / execution.* New managers formed by senior executives that have left large investment organizations may not be able to access the types of deals that they did when they had a large organization (i.e., it may have been others sourcing deals). In addition, newer and smaller firms may not see the deal flow that more established groups do, due to the need for surety of execution on the part of some sellers.
- *Less 'institutional' mindset and processes.* Certain new groups, particularly those who have operated as developers, may not have the in-house processes in place to operate in the manner of a fiduciary or be equipped to think about investments at the portfolio level.
- *Resource constraints.* Newly created firms often cannot staff up significantly, and therefore may suffer from being under-resourced in areas which are critical to investors such as portfolio management, asset management, and/or accounting and reporting. In addition, senior executives must spend a significant amount of time raising capital rather than making investments.
- *Enterprise risk.* Even after the high barrier to entry discussed above, newly created firms carry with them a risk of failure. They may not have a series of deals, funds and/or separate accounts and therefore the accompanying fees to "keep the lights on." They run the risk that the significant near-term costs of building a business become too burdensome before profits can be created.

There are challenges and risks to investing with new managers, but there are also unique opportunities. As the real estate cycle and the cycle in the investment management business both continue to evolve, there will be further consolidation among investment managers and room for new firms to be created, grow and replace those that disappear. During this continual evolution, it is important for investors to create and capitalize on new relationships, while recognizing and managing the unique risks of new managers.