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The Case for Small and Emerging Private Real Estate Managers: Benefits of Including Small-Cap Managers in a Diversified Portfolio of Private Real Estate Investments

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Interest in investing in private real estate funds from emerging managers has been increasing. Emerging managers are typically considered to be small, recently established property fund managers that are raising a first or second fund, or managers who consistently focus on the smaller real estate deals in their local markets. In addition to evidence from private real estate data, studies of other asset classes also illustrate that smaller funds and fund managers have historically outperformed their larger peers. The aim of this paper is to summarize the potential benefits and risks associated with private real estate emerging manager investments and to suggest the possible advantages of including small-cap private real estate managers as part of an investment portfolio.

INTRODUCTION

The opportunity to invest with emerging managers may be attractive to many institutional investors, and investors in hedge funds, private equity, long-only equity and fixed income often seek such access. Investors in real estate now have expanding opportunities to invest both in a variety of strategies and with small and emerging managers. There is no fixed definition of an "emerging manager," although fund size and total assets under management are key criteria. Other criteria could include the number of clients, years in business, size of the team, track record and the number of funds raised. Typically, the term refers to managers raising their first or second fund, with a fund size that generally remains below $500–$750 million.

The performance that small and emerging investment managers have been generating compared with their more-established, larger counterparts has been attracting the attention of institutional investors across asset classes. In addition, smaller managers have tended to be more focused on their strategy, better aligned with investors and more adaptable to changing market conditions than their larger rivals, thus potentially supporting favorable relative performance in downturns as well as upturns.

Even in the midst of the recent financial crisis, several large pension funds and other institutional investors expanded their emerging manager programs or announced plans to do so. This has continued a trend seen over the past decade of investors actively expanding the types of assets in their portfolios and embracing new investment strategies as they seek additional alpha and broader diversification. In our view, the emerging manager opportunity in real estate can be best accessed through the private real estate sector. Emerging private real estate managers have the potential for success without the large asset base often required by "core" real estate managers.

Emerging managers in real estate tend to be strongly motivated to exploit market inefficiencies, as they are intent on proving themselves in order to build a track record. Thus, frequently these managers are intensely focused on generating "best ideas" and have often been able to build liquid portfolios of "below-the-radar" opportunities, owing to the smaller amounts of capital available per investment.

Similar to the hedge fund and buyout fund industries, large private real estate firms often lose experienced professionals to new platforms. Furthermore, in recent years many experienced local partners of larger private real estate managers have decided to launch their own funds. Often, these teams have substantial real estate experience, having built up significant track records in their previous positions. While many institutional investors either choose not to invest—or are not permitted to invest—in funds started by newly established managers, a growing number of limited partners ("LPs") are doing just that.

One concern about investing in smaller managers is the potential for volatility. Although emerging managers may provide higher-than-average returns, the volatility of the returns achieved can be far more significant than that of more established managers. Thus, diversification and in-depth due diligence are crucial when investing with emerging managers.

For example, investing with emerging managers provides diversification in smaller private real estate funds and typically smaller deals. This diversification may be seen as an attractive satellite strategy for an investor's overall real estate allocation. However, care should be taken to evaluate the opportunities and potential risks that stem from investing in smaller real estate funds, which are often sponsored by emerging fund managers.

Some of the key potential benefits and concerns associated with emerging and small-cap managers are summarized in Table 1 and explained in the pages that follow as we move through the various areas of a comprehensive due diligence process.

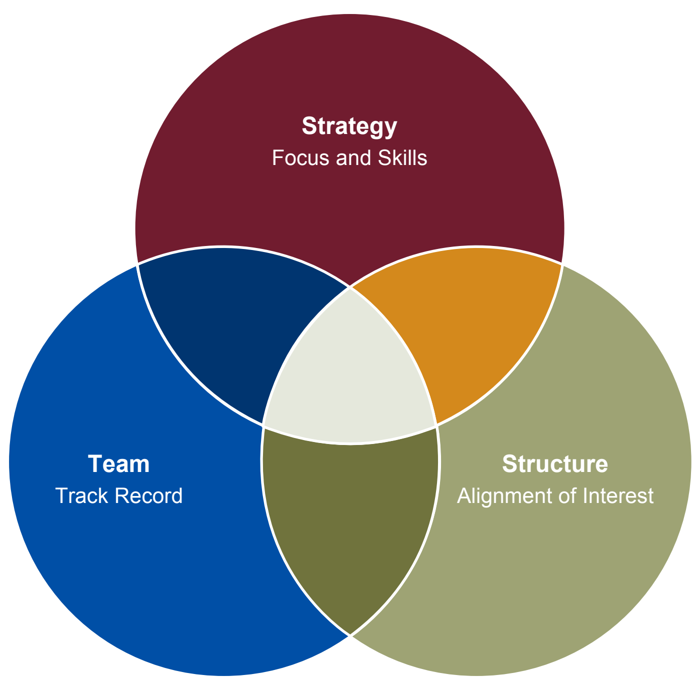
Table 1: Investing in the Funds of Emerging Managers

Potential Benefits	Potential Concerns
• Focused strategy, local market knowledge • Focus on single assets • Active, hands-on management • "Below-the-radar" deal sourcing • Strong alignment of interests with investors • Motivated to build track record • Flexible and adaptable • Potentially attractive terms and control rights • Potentially lower use of leverage • Typically smaller transaction sizes result in smaller loans • Historically attractive performance • Focused on cultivating future talent	• New teams still forming; harder to evaluate effectiveness • Limited or nonexistent track record • Difficult to differentiate between stronger and weaker managers • Fundraising often challenging • Potential outperformance may come with greater volatility

DUE DILIGENCE FOR SMALL AND EMERGING MANAGERS

When conducting due diligence on private real estate managers, investors should focus on a variety of criteria, including the background of a fund manager's team, the investment strategy, focus and processes; the fund structure and alignment of interests; and ultimately the manager's track record (see Chart 1).

Chart 1: Key Investment Criteria



The above chart is for illustrative and discussion purposes only.

MANAGEMENT BACKGROUND, FOCUS AND SKILLS

Conducting due diligence on small and emerging fund managers can encompass the same areas of investigation that are typically explored for more seasoned fund managers, but the process must go further. The key differentiating factor is the greater attention that needs to be paid to manager analysis and to the potential risks particular to emerging managers. A comprehensive approach should help differentiate between those managers who may succeed and those who may fail.

For investors, it is important to distinguish between newly formulated teams seeking to launch a fund and first-time funds raised by seasoned, cohesive teams. There are teams raising a first fund that have worked together in the past, while other first-time teams may include individuals with various levels of experience who are entering the fund management arena for the first time. Both types of teams may prove to be solid performers, but their risk profiles can differ dramatically. Understandably, higher risks will be associated with those first-time teams that have no previous experience in fund management.

In private real estate, smaller entrepreneurial firms have often been formed following an exodus of talent from larger, more established investment firms. In many cases, these emerging funds have been launched by veteran professionals and seasoned managers with extensive experience, as well as with broad real estate networks. In our view, these qualities are crucial for building successful investment and business platforms. However, often as real estate funds have grown larger and have become more established, they have become less nimble and not as focused on their original performance goals and investment strategies. When this has occurred, talented investment professionals—motivated by a desire to preserve and retain their performance track record—have in many cases decided to create spinoffs and launch new platforms. The credit crisis has produced an additional surge of emerging managers as many existing real estate funds have been consolidating or dissolving, or have lacked the financial resources necessary to retain top talent. Lastly, the local operating partners of larger managers have increasingly initiated their own operating platforms and funds. Overall, the surge in emerging private real estate fund managers in the market has, in our view, been instrumental in creating more avenues for potential success, growth and sustainability.

As a result, the sponsors of funds and institutional investors are being exposed to a more diversified pool of top-tier managers across a number of new investing concepts. For example, investors have become increasingly interested in socially responsible investing, with initiatives such as the United Nations Principles for Responsible Investment (UNPRI) and Minority and Women Business Enterprises (MWBE) moving beyond simple promotion of broad investment platforms. With respect to promoting manager diversity, institutional investors have increasingly encouraged the inclusion of MWBE funds within their investment programs and are developing and implementing allocations that exclusively target that sector. Although historically, a large number of emerging manager firms have been minority and women owned, these initiatives have provided extra support for the launch of new MWBE-owned real estate funds. The increased attention from corporate and government bodies on socially responsible investing may spur the further development of MWBE funds and has the potential to offer additional competitive advantages for this category of emerging managers.

ALIGNMENT OF INTERESTS AND BETTER INVESTOR CONTROL

Among the benefits of a small fund manager is the general partner's ("GP's") typically close alignment of interests with that of the LP. This results from the meaningful amount of personal capital that the GP will generally have invested in the fund. Also, given that emerging managers are often focusing on fewer legacy investments than are larger, more established funds, the GP of an emerging manager should be better able to concentrate on sourcing new investments. Small funds tend to have investment strategies that are tightly focused on specific sectors or countries, and that are run by dedicated and highly knowledgeable teams. Additionally, as a result of their relatively limited capital resources, emerging managers can typically offer LPs more coinvestment opportunities, in which the LP makes real estate investments directly alongside those made by the GP.

Because fundraising activity has dropped significantly from levels seen a couple of years ago, the investors who have remained active have noticed a significant increase in their negotiating power. The total capital commitments raised by private real estate funds decreased significantly in 2009 compared with previous years. According to Preqin, in 2009 a total of $48.6 billion was raised by 129 private real estate funds globally, compared with $137.1 billion raised by 243 funds in 2008.[1] In the first two quarters of 2010, 37 private real estate funds raised globally a total of around $17 billion—roughly comparable to levels last observed five years ago.[2] Fundraising has also been taking almost twice as long as before the financial and economic crisis that started in 2007, with an average marketing period of close to 20 months. As a result of this environment, fund managers attempting to raise capital—and especially small and more recently established ones—may be willing to provide investors with relatively attractive terms.

Without assuming liability for involvement with actual investments, LPs can often have more influence on the investment strategy and investment guidelines/limitations of emerging managers than on those of established managers. This can lead to better risk management and diversification rules in the investment documentation. Typical investor rights—such as a comprehensive "key-man" clause, as well as "no-fault divorce"—are becoming standard in operating agreements for real estate limited partnerships. At the same time, investment limitations are often tailored to ensure that portfolios remain in line with the set investment strategy. In particular, rules on diversification and use of leverage may be more negotiable under LP scrutiny.

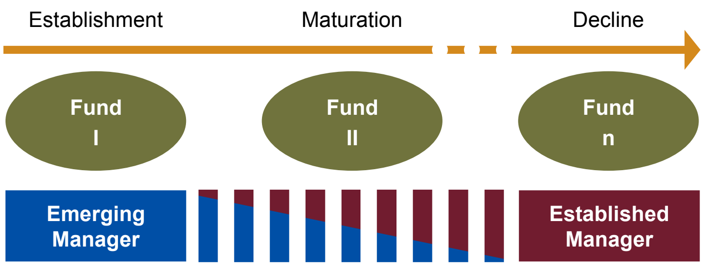
Fees have also been changing in the wake of the recent market turmoil. Fewer managers have been proposing acquisition or disposal fees. They have also become willing to consider budget-based base management fees. Perhaps more importantly, the performance fee (carried interest) models have been changing. The previously popular 20% performance fee over an 8% internal rate of return (IRR) hurdle is now becoming more LP friendly, with "catch-up" clauses becoming less aggressive or disappearing completely. Hurdle returns have also been getting closer to the target returns, allowing fund managers to receive their carried interest only if they are reaching their target returns. Performance fees for emerging managers are often calculated on a fully back-ended basis, to guarantee that LPs have received their invested equity and hurdle return prior to any performance fee payments to the manager.

TRACK RECORD AND ITS EVOLUTION

While making decisions on whether or not to invest in a new fund, investors are focused on fund strategies and how fund managers differentiate themselves from their rivals. Managers of recently launched funds are strongly motivated to establish a good track record in order to pave the way for future growth, as many investors focus on track record when selecting new private real estate investments. While smaller managers generally have higher relative costs than larger funds due to a lower asset base, they are often able to find more cost-efficient ways to invest than their larger rivals. There also may be greater fee "leakage" from large funds, as they commonly allocate capital commitments through local partners. The local partners will frequently have fee arrangements in place that result in a doubling of performance fees, with the local operator and large fund manager each taking a share of the profits. By contrast, in many cases emerging and smaller managers have acted as local partners to large allocator funds before deciding to raise a fund of their own.

Consistent performance and a favorable track record are important factors to consider when evaluating the potential for future success. To maintain a continuous portfolio of properties under management, GPs need to raise new funds as soon as the capital from LPs is fully invested. The challenges inherent in initial fundraising generally provide prospective LPs more leverage in negotiations. The small size of new funds typically pushes emerging management teams to raise subsequent funds in order to generate greater wealth, as the first fund of such managers rarely makes them wealthy. The relationship between fund managers and investors often evolves over fund sequences (see Chart 2).

Chart 2: Fund Manager/Investor Relationship



The above chart is for illustrative and discussion purposes only.

After the launch of a first fund, successful GPs will seek to raise and invest more capital. The goal of these subsequent launches is to build multiple portfolios that will allow the maturation phase to last over a number of fund sequences. During that period, successful managers often develop a loyal investor base. In funds where the fund construction has been prudent and the track record has remained strong, management can be encouraged by investors to adopt a disciplined approach to future growth, and create substantial wealth for themselves and their investors. In our view, compared with large managers, this discipline results in emerging managers being less likely to exhibit style drift and take on additional risk in subsequent funds, allowing for a more consistent return stream over time. Therefore, emerging manager funds can provide a very high level of alignment of interests.

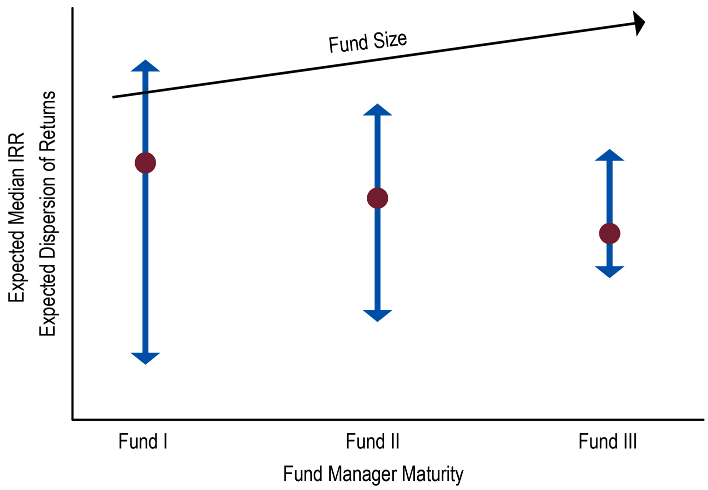
However, even with successful emerging managers, each time a new fundraising takes place, investors need to assess if the "star brand" image generated by the initial successes remains as enticing. Reasons for declining to invest in a new fund could be performance related, based on a significant growth in target size or for style drift. Often, team turnover and succession issues become an issue with subsequent funds. In real estate investing, tactical allocation decisions by LPs can involve notable changes in country and sector allocations from time to time. Thus, the LP-GP relationship can be more complicated for real estate funds than for traditional buyout funds. In addition, more aggressive terms on the new fund offering may be a sign that manager and investor interests are becoming less aligned.

Of course, an emerging manager may be removed from an approved list simply for having become too large, which can easily occur before the manager has lost his/her luster.

Additionally, while private real estate investing should theoretically be countercyclical, historically fundraising has typically been positively correlated with the performance of the underlying investment market returns. That is to say, more and larger funds have been raised during times when real estate prices have already increased. The level of fundraising has typically dropped after declines in capital values. The best-performing fund vintages have, therefore, been those that were raised during times of market distress and limited competition. Evidence from private equity buyout funds has also shown that better-performing fund managers have been likely to raise larger follow-on funds than poorly performing fund managers. There is also evidence suggesting that top-performing fund managers' follow-on funds have historically not grown proportionally as much as the average fund.[3]

Recent research has illustrated that the performance of small real estate funds has been negatively correlated with both fund size and fund sequence. We believe that this supports the view that emerging fund managers may be more likely to reach above-average performance.[4] However, an attempt by a successful emerging fund manager to disproportionately grow the size of a follow-on fund should serve as a red flag to an investor. Significant growth in the size of a follow-on fund may cause style drift, as the manager's focus shifts from small deals to larger and often more competitive situations. The hypothetical connection between the evolution of fund size and its potential effect on returns is illustrated in Chart 3. The overall risk and volatility in IRRs achieved are lower for more established managers, but the returns may be as well.

Chart 3: Possible Evolution of Fund Returns from First to Third Fund



"Fund Manager Maturity" as shown in Chart 3 above illustrates the theoretical universes of first, second and third funds, aggregated from among all managers launching funds. "Expected Median IRR" illustrates the theoretical median internal rate of return (IRR) earned by an LP after fees and carry, and depicts the potential dispersion range of returns for first, second and third funds. The above chart is for illustrative and discussion purposes only.

POTENTIAL DIVERSIFICATION WITHIN A LARGER PORTFOLIO

An investor who allocates capital to private real estate should seek diversification by investment manager, geography, real estate sector, investment style and time horizon (vintages). Diversification across multiple investment managers—both large and small—is important as well. Many investors prefer country- and sector-focused funds that raise less than $1 billion in commitments.[5] Typically, emerging managers fill these preferred characteristics.

One strategy for achieving this diversification is to invest via a multimanager, "fund-of-funds" structure. In this approach, an investor invests in a fund which in turns invests in underlying private real estate funds. In such a vehicle, a fund operator with specialized real estate investing expertise performs substantial due diligence on the underlying funds. The fund operator then presents investors with a fund comprised of a pre-screened basket of underlying private real estate funds. These investments may include emerging funds and access to niche real estate strategies. Multimanager investing also tends to shift the demands of the rigorous due diligence required for small funds away from the investor.

Emerging managers may also provide opportunities to participate in smaller and off-market transactions, which tend not to be on the radar screen of larger real estate funds. There can be less competition for smaller deals, resulting in potentially more attractive entry pricing for these investments, even during boom years. Most investors in established private real estate programs are invested in a number of funds. Managers of these funds may occasionally compete on the same deals. Thus, allocations to smaller managers may serve to diversify the targeted opportunity set of the underlying real estate investments. Smaller managers have also historically often relied less on high leverage than their larger rivals and have tended to emphasize active management and the exploitation of inefficiencies not frequently accessible to larger managers.

Additionally, smaller managers can be attractive to lenders seeking to relieve the concentration risk associated with larger managers' loan size. Notably, with banks more reluctant to underwrite large loans than before the financial crisis, the gap between the resources that smaller and larger funds can raise has narrowed. Frequently, financing programs for small real estate funds can be offered without the need for large syndications or securitization packages. The prevalence of such syndications and securitizations was dramatically reduced as the global financial crisis took hold over the last few years. Finally, local managers often have close relationships with regional banks and therefore tend to be less vulnerable to conditions in international markets.

CONCLUSION

Despite challenges faced by real estate funds in the wake of the recent financial and economic crisis, institutional investors remain committed to private real estate investing. Results from a recent Preqin PERE Investor Survey indicated that 75% of respondents were confident in the private equity real estate market in the long term.[6]

Private real estate has been maturing and evolving as an asset class. As this occurs, in our view it is important for investors to enable the sector to foster, develop and encourage the growth of new managers. This has been the pattern in recent decades that has occurred in other alternative investment management sectors. Hence, these sectors have benefited from an ongoing inflow of new entrepreneurial talent. Because of the favorable performance such funds have historically produced, interest in them by institutional investors has been rising. Socially responsible investing has not yet been broadly embraced by institutional investors, but a focus on that area has been increasing as well. Such interest may extend to emerging managers working in private real estate.

Although the median and top-quartile performance of emerging real estate funds may exceed that of more established funds, the performance of smaller funds has typically been more dispersed, showing a broader range of performance on both the upside and the downside. Alongside this potential outperformance, there also exists a greater level of risk associated with firms that lack lengthy track records. This highlights the importance of meticulous due diligence.

As a result, many investors in emerging managers focus on enhanced diversification and limit the commitments per manager and fund. An alternate approach for achieving diversification is to invest via a multimanager fund. With this type of investment, an investor may limit the risks associated with small managers, and potentially benefit from the expertise of specialist investment professionals who utilize established investment processes.

NOTES

1. Preqin (2010), *Real Estate Online Database* as of July 13, 2010.
2. Preqin (2010), *Preqin Research Report Q1 2010 Private Equity Real Estate Fundraising Update.*
3. Kaplan and Schoar (2005), Private Equity Performance: Returns, Persistence, and Capital Flows, *Journal of Finance*, Vol. 60, No. 4, pp. 1791–1823.
4. Tomperi (2010), Performance of Private Equity Real Estate Funds, *Journal of European Real Estate Research,* Vol. 3, Issue 2 (forthcoming).
5. INREV (2010), *Investment Intentions Survey 2010.*
6. Preqin (2010), *Preqin Research Report PERE Investor Survey: Looking Back and Moving Forwards.*

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