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Navigating Trust

In Turbulent Times, Client Relations Really Matter

by Jennifer Williams

Bernard Madoff, subprime lenders, crumbling Wall Street banks and Enron fraudsters have given investors more than one reason to think twice before they part with their money. Today, trust is not something investment managers can afford to take for granted.

Real estate investing used to be so easy. You could buy property anywhere in the world, leverage it, then sit back and watch its value increase. The terms of the loans didn't matter because property values were going to keep going up, forever and ever. You could always refinance.

But then one day, the strategy that had been working so well — getting out of bed in the morning — failed to produce the expected double-digit returns. Suddenly nobody could refinance anything. For both investors and plan sponsors, life became a lot less fun than it used to be.

HIGH ANXIETY

"Clearly, fear rules the day right now," says Chuck Carpenter, managing director of private markets for the State of Wisconsin Investment Board. "There is absolutely no trust in the markets."

Models that seemed perfect in good times began to show their flaws when times became less than perfect.

"I've done enough workouts over the years to see that the alignment-of-interests structure can go into reverse when the market goes into reverse," says Ted Leary, president of Crosswater Realty Advisors. "And rather than interests being aligned, it becomes every man for himself, and everybody's protecting their interest and their company and their revenue. That's what happens when markets go bad, and I think that is happening out there today."

With the number of workouts on the rise, Crosswater recently formed within the company a senior adviser group that provides workout, value recovery and commingled fund/partnership restructuring assistance.

"The most recent wave of structures was based on a moderate asset-management fee that was supposed to cover your costs, maybe give you a small profit," explains Leary. "Your real profit was going to be in some kind of incentive or performance fee. That's what produced the gold at the end of the rainbow.

"But the rainbow's gone. There are no incentive fees going to come out in the recent-vintage funds, because the returns are negative. You don't make incentive fees when you have negative returns."

Leary continues: "From an adviser's point of view, if those performance fees have disap-

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peared, you're living on your asset-management fees, which are tied to assets under management values. When those values go down, revenue goes down. So there's a clear conflict at that point; the manager doesn't want to see his values go down, although the market in fact may be going down. That's where the alignment-of-interests concept goes into reverse. And that creates problems in relationships."

Which bring us to the uncomfortable topic of write-downs. Wisconsin's Carpenter says one fact is clear: "Anything that you bought before 4 o'clock, Monday afternoon, Dec. 1 [2008], you paid too much for. Because prices were at a bottom then, and they've come down since then. Through the last three years, there was no way you could be bearish enough in describing what was coming."

It's a bitter pill: The sooner an investment manager writes down the value of property, the sooner he starts seeing reduced asset-management fees. It's also tough to know exactly how far to write down an asset.

"One of the challenges today is that there are so few transactions out there that nobody really knows what values are," Crosswater's Leary says. "So you can probably slide by for a while in not taking your write-downs, but over time you'll have to."

COMMUNICATE CLEARLY AND OFTEN

Leary predicts that the investment managers who are going to survive the downturn and prosper on the rebound "are the ones that come in early and tell their clients they've got write-downs. Because they know. People know. They don't need a hundred comps to know what's going on in the marketplace. The people who come in early — even if it's not required — will be the ones who gain and retain the confidence of their investors. The people who drag their feet are probably going to be the losers because the clients will lose confidence in them.

"Be really open and honest about your assets, the markets, the values," Leary advises. "You've got to be honest about the status of your organization. There have been significant layoffs across the industry. So one of the questions a client needs to have today is, 'Explain to me who's managing my assets.'"

Jill Katz, a principal at Koza Partners, echoes those concerns. "There's a tremendous amount of uncertainty in the marketplace in general," says Katz. "But between plan sponsors and managers, I don't think we've come to a place where there's a lack of trust. It's more about anxiety, and disappointment when you find out after the fact that something went wrong. 'Are my fund investments still on strategy? Are we going to have capital calls that are inappropriate? What's going on?' Those are the key questions from the plan sponsor side."

Koza Partners, a consulting firm serving real estate managers and advisers with offices in San Francisco and the East Coast, advises clients on client relations and business strategy relative to raising capital.

Investment managers, meanwhile, need to be upfront and to share information in a timely manner, Katz says: "Always have a plan about what you're going to do. Share that plan with your sponsor, because sponsors are anxious, and they have a right to be anxious."

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— Jill Katz, principal, Koza Partners

"It should be an open book," says Carpenter. "Investment managers need to provide 100 percent full disclosure of the issues."

When an action needs to be taken on an investment, Carpenter says, all the players should meet jointly to discuss it. If a face-to-face gathering isn't possible, he prefers a conference call that all limited partners are invited to attend.

"In these last couple of years there has been a love affair with real estate that's not realistic."

— Ken Lambert, CIO, Public Employees' Retirement System of Nevada

"The alternative to the conference call is the manager calling up each individual LP one at a time, which reads like a divide-and-conquer strategy," Carpenter says. "We like to hear what other investors are thinking, and we like to hear answers to other investors' questions. It's very clear that what limited partners are looking for is to see that any proposed actions taken by the managers really need to be put to the LPs first."

RETURN TO REALISTIC EXPECTATIONS

Heeding the lessons of history can go a long way toward assuaging the anxiety plaguing today's markets.

"In these last couple of years, there has been a love affair with real estate that's not realistic," says Ken Lambert, CIO for the Public Employees' Retirement System of Nevada. "It's true that during the last decade, real estate has outperformed both stocks and bonds. But that's not a realistic position for that asset class."

He points to previous down cycles: "If you look back, during most of the '80s and mid '90s, real estate underperformed bonds. For the last 10 years, core private real estate has delivered a return of about 12 percent per year. In our opinion that is not a sustainable long-term return.

"It's very realistic to expect negative returns for the next couple of years from real estate, and I don't think that's a bad thing," Lambert adds. "That's a normal market cycle."

In other words: What goes up must come down. With the market overall in bad shape, anyone who has a portfolio is likely to be in some degree of trouble. And when property values have to be written down, it's not necessarily the fault of bad decision making.

Carpenter says, "Investments that were made over this past summer may be good investments, but you're underwater right now."

STAYING ALIVE

Whether underwater assets have to be sold at distressed prices depends, of course, on when the loans are due.

"Most people would want to hold until things improve if they have the balance sheet," Carpenter says. "So if you haven't used debt, then you can likely hold. You would have to explain to your board, the people you report to at your organization, why you're going to be OK in the face of all the bad news — the wave of bankruptcies that's picking up, the wave of foreclosures in commercial real estate.

"Whether it's real estate manager meetings I've gone to or private equity, the GPs — the good GPs — are talking about what they're doing to maintain cash solvency," adds Carpenter. That means making the most of what you have: reducing inventories as much as possible, and extending accounts payable, i.e., taking longer to pay obligations.

"The real key is you reduce inventory, you reduce your accounts receivable — you want to get your money as soon as possible from your customers," Carpenter says. "You focus unrelentingly on your operating costs. You do whatever it takes to build cash flow. Whatever you do, you don't break a loan covenant — the same thing is true on the real estate side. It costs so much to have your lender waive any loan covenants you've broken. They'll increase the interest rate, they'll make you pay a principal paydown at par, they'll make you pay an upfront fee of 2 to 5 percentage points. It's just punitive.

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— Chuck Carpenter, managing director of private markets, State of Wisconsin Investment Board

"The best managers, some of them saw this coming in the last part of 2007," Carpenter continues. "They tried to get sales done, or refinancing things done, or extended their financing. And so we'll just see. You're probably in good shape if you extended your financings out so you don't have any maturities until 2012. That gives you another two and a half years. But I don't know if it's going to be long enough."

There clearly wasn't enough time for a number of troubled funds. A commercial property debt fund run by Guggenheim Partners, for example, saw tens of millions of dollars in collateral seized by JPMorgan Chase late last year. JPMorgan began auctioning off the collateral after the fund failed to come up with additional capital to meet margin calls.

The fund developed leverage problems, similar to other funds that have invested in debt used to finance commercial property. The Guggenheim fund had raised only $770 million in initial equity, but it used leverage to purchase more than $2 billion in commercial real estate assets.

The Guggenheim fund, along with another $1.5 billion real estate debt fund with investors including the family of former presidential candidate H. Ross Perot, was forced to liquidate to pay off creditors, according to *The Wall Street Journal*, which in December 2008 reported the story.

"The short-term debt triggered margin calls as the weakening economy wreaked havoc in the commercial real estate debt market," the *Journal* reported. "Under the terms of that debt, a drop in the value of the fund's collateral led lenders to demand additional cash." The Guggenheim fund repaid some creditors, including Credit Suisse Group, by selling assets. Then it asked investors for about $300 million in additional capital to help pay down borrowings. When it couldn't raise the additional capital, JPMorgan demanded the collateral on its loan to the fund.

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"That [Guggenheim] fund just ran out of time," Carpenter says. "And this is an example of why assets are being sold. JPMorgan is going to sell these assets at any price. They have to get liquidity just to pay themselves back some margin financing.

"The loans in reference in this case, the bulk of them are still performing," he points out. "But the price that these assets sell for — the assets on the fund's balance sheet, the loans are the fund's assets — the assets sell for such declining prices because there are so many sellers. That's what triggered the margin calls. It doesn't necessarily have anything to do with the performance of the loans. They're still performing, but the price that you can get if you have to sell these loans in a week or less has dramatically fallen. It's just a sign of the times."

GETTING BACK INTO THE GAME

Falling prices present an opportunity to buy low. But the question now becomes which pension funds and other plan sponsors will have the flexibility to take advantage

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– Chuck Carpenter, managing director of private markets, State of Wisconsin Investment Board

of it? Some pension funds are selling stock to pay benefits because they don't have enough liquidity in their fixed-income portfolios.

"The real challenge is to be able to still take advantage of deals in the market, even when your existing portfolio has issues," says Lambert, the Nevada PERS investment officer. "A successful investor has to be able to invest through the entire market cycle, not just when things are going well. It's easy when everything is going great."

The big questions for plan sponsors now are: Are you going to be able to buy low? Are you going to have access to capital in the down market? If we see a negative return environment for the next 24 months, can you allocate capital in that environment? And, perhaps most importantly, can you trust what your managers have been telling you about your portfolio?

"The denominator effect may make it difficult for plan sponsors to take advantage of deals in the market," says Lambert. "It is pretty hard to give money to real estate managers if you are over your allocation and liquidity is tight. Paying benefits is always the number one priority."

Nevada PERS, an all-cash investor with a $19 billion portfolio, is willing to exceed its 6.5 percent allocation to private real estate. "We are comfortable exceeding our target in the short term if it gives us the opportunity to take advantage of mispricing in the real estate market," Lambert adds.

THINKING LONG-TERM

Good deals will be out there. But whether managers will get the nod from investors depends largely on the stability of their relationships. Investment managers need to explain how they are positioning themselves for a negative return environment.

"Remember this is a people business," says Crosswater's Leary. "The assets are real estate, but the businesses are people businesses. People who go in and say, 'The market's crashed, this is what we're doing about it' — those are the people who will retain the trust. People who aren't straight shooters may pay a penalty for that."

Wisconsin's Carpenter concludes: "It's going to be very clear to LPs if a GP or a manager is not acting as a fiduciary. LPs have a long memory. And this could be one of those times when long memories are created." ❖

Jennifer Williams is editor of *Institutional Real Estate Dealmakers.*