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The Financial Crisis Has Highlighted Key Needs for Creating and Maintaining Positive LP and GP Investment Relationships

by Alex Frew McMillan

The ties that bind the limited partners that invest in real estate funds to the general partners that manage them have been worn hair-thin by the financial crisis. How can the two "sides" best work together now?

Before the financial crisis, it wasn't unusual for general partners (GPs) to create funds that were targeting equity commitments of US$1 billion, US$3 billion, US$5 billion — and still be oversubscribed. Limited partners (LPs) blinded by the real estate bull market that ran through 2007 tripped over themselves to invest in funds from big Wall Street names — who sometimes said they didn't need their money, and returned it. At times, LPs weren't sure where to turn to maintain their allocations to real estate.

Life has, of course, been turned upside down during the past three years. A market where GPs certainly held the upper hand now squarely favors the LPs that invest with them. LPs are being a lot more skeptical, and are finding at times they are able to dictate terms to the GPs.

So where does that leave the investor-asset manager relationship? The credit crunch has reminded the real estate world that, if you're investing other people's money, you should also answer to them. Investors are realizing they should never place a manager on a pedestal.

"It has dawned on them that the GPs are not the masters of the universe that they marketed themselves to be," says Ted Leary, president of Los Angeles–based property investment consultancy Crosswater Realty Advisors. "In many ways the biggest firms have got the biggest problems and have lost the highest percentage of assets."

BIG NAMES TAKE A BEATING

For investors that prized reputation and size, there have been some shocking failures. Morgan Stanley in mid-April warned investors that its Morgan Stanley Real Estate Fund (MSREF) VI is facing a potential loss of as much as US$5.4 billion, from an original fund size of US$8.8 billion.

That looks set to be the largest in the history of private equity real estate investing. In some investments, such as a €2.1 billion (US$2.6 billion) portfolio of German offices, and a US$800 million portfolio of European hotels, the fund walked away from all its equity, simply handing the keys back to the lenders.

At Goldman Sachs, the Whitehall Street International real estate fund has fared no better. The fund estimated in mid-April that it had lost 98 percent of its original US$1.8 billion in equity and was down to its last US$30 million. Goldman Sachs was the largest single investor in Whitehall, with a commitment of US$436 million. In addition, Goldman Sachs took a loss of US$1.76 billion on its real estate principal investments in 2009.

Despite those losses, the managers continue to roll out new products. Morgan Stanley has raised the MSREF

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VII Global fund, which is reportedly in the process of investing in the United Kingdom and the United States.

But it will not be business as usual as GPs look to raise money, according to investment professionals now advising LPs on their approach. "There is this skepticism in the LP community about the GPs," Leary notes. "They naturally want more input in decisions, and that will lead to some interesting decisions about control." Leary expects the biggest pension funds to push through special terms and force investment managers to create separate managed accounts that are run on a standalone basis, while smaller investors will be left with no alternative but to invest in funds. "You may have a bifurcated market where big gorillas are doing their own thing," he says.

"Investors are in most cases finding it's in their best interest to work with their managers — it's probably less adversarial than one might lead you to believe."

— Anthony Frammartino, partner, The Townsend Group

MANAGEMENT FEES TAKE A CUT

Jennifer Johnstone Kaiser, the Sydney-based head of real estate for the Asia Pacific region at investment consultancy Mercer, says she has seen only a minor scaling back of fees, for example, with base management fees falling to 1.25 percent from 1.5 percent plus on committed capital. "There's an acceptance that the investors would rather pay on invested capital and, while some mangers are prepared to discuss this in new equity raisings, it is unlikely to be a widespread trend unless the weight of capital applies pressure," she says. "We do recognize that investing in pan-Asian or European strategies, particularly higher up the risk curve, requires skilled, multilingual teams that should be appropriately incentivized. We are more concerned with hidden fees and if the preferred return threshold is lowered."

Management fees should reimburse the manager for its costs but should not become an end in themselves, investment advisers say. Some suggest that the cuts in fees have not gone nearly far enough. "If I had my way, they would be less than 1 percent," Leary says. "The GPs were getting rich just off asset management fees. I think those days are over."

There also will be greater attention paid to incentive fees. At times, these fees have created the wrong kind of incentives and have even encouraged style drift. For instance, a core fund's role is often to act like a real estate bond, producing stable amounts of income through rents. Some consultants have raised concerns that an incentive fee encourages unnecessary risk-taking by a core manager; they have instead suggested that very conservative property funds should only charge a management, and not a performance, fee.

Another structural change could see performance fees structured so that they do not accrue during the life of the fund but only at its end. That might create pressure to shorten the lifespan of funds but should ensure the manager doesn't get paid unless the investors are making money.

Some consultants are asking for clauses to be written into investment contracts that would make it easier to terminate the general partner. "We request and are now receiving the right to remove the GP without cause," says Anthony Frammartino, a partner with The Townsend Group. "It's higher on our list of priorities today than in the past."

There is some concern that investors may take their demands too far, making life difficult for well-meaning managers. But the relationship seems to be cordial for now. "Investors are in most cases finding it's in their best interest to work with their managers — it's probably less adversarial than one might lead you to believe," Frammartino continues. "No one is served well by ending these things hastily."

Still, limited partners may now realize they were too passive in the boom times for property, deferring to the reputations and track record of the general partners they were investing with. Now investors are likely to

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be much more vocal and proactive. "Investors have been burned and are wiser, and therefore will be far more critical," Mercer's Johnstone Kaiser says. "They will be scrutinizing investment managers far more readily. That is not to say we expect them to become involved in investment decisions, rather, GPs and funds managers should assume that lack of regular communication is bad form."

"It is down to the LPs to impose this new regime on the GPs," Leary agrees. "I think the managers need to be reined in and restructured."

ASIAN SOURCE OF CAPITAL

LPs based in the United States are likely to be the most adamant about revamping the investor-manager relationship. Investors in Europe and Asia have traditionally been less vocal, and in Asia in particular they have generally not been as badly burned in the downturn.

Asia is playing an increasingly important role as a source of investors and capital, however. Major pension funds and sovereign wealth funds have been emerging from Asia, and many of those institutions are sitting on significant levels of cash that they need to put to work.

"We have started to see a change," Johnstone Kaiser says. "A number of pension funds are sitting on significant levels of undeployed capital. They are in a sweet spot and have started to deploy in a counter-cyclical way."

It's clear that more and more general partners will be booking flights to Asian airports. Nearly one-third of the GPs or private equity firms in the United States and Europe expect their future fund-raising efforts will take them to the Asia Pacific region and the Middle East for the first time, according to a study released in mid-May.

"The survivors will be the ones that have the greatest transparency and the best communication with investors."

— Ted Leary, president, Crosswater Realty Advisors

The white paper, "Private Equity Faces the Future: Candid Views from the Market," was put out by BNY Mellon and Private Equity International. "GPs are seeing many Asian LPs as having a strong appetite for the asset class, many of them managing relatively young programs with significant target allocations to put to work," the study notes. GPs also have found new types of LPs such as sovereign wealth funds and large corporations that are looking to expand their investment in alternative asset classes.

But when it comes to soliciting investment from Asia, there is still resistance at the board level. The Mellon study shows that only 14 percent of Asian investors expect to increase their allocations to private equity, with 71 percent maintaining their current investment levels. That's similar to the breakdown in Europe but a far cry from the United States. Board members at 40 percent of Asian LPs had "recently adopted a more negative view" of private equity, compared with 25 percent in Europe and only 14 percent in North America.

"While LPs in Asia are enthusiastic about private equity, they recognize that there remains a gap in education and experience," Andrew Gordon, the head of BNY Mellon's alternative investment services group in Asia, says. "In turn, GPs need to adapt by building a sophisticated infrastructure to service investors throughout the economic cycle."

COMMUNICATION

Improving communication with investors is a vital strategy for asset managers, investment professionals say, and is particularly important during bear markets and downward economic cycles. Investors often understand that markets in general are hurting, and may accept that investments are producing losses — as long as the manager is upfront about that fact and comes up with a plan to rectify performance.

"There will be a lot of people who go out of business — it's happening as we speak," Leary says. "The survivors will be the ones that have the greatest transparency and the best communication with investors. That is really becoming a very telling factor."

Jill Katz, who works at San Francisco–based Kosa Partners and advises GPs on how to evaluate and maintain their investor base or promote new funds, agrees that communication is key and that in some cases there was a total breakdown in the relationship in the past year between investors and managers.

The majority of general partners have not been good at communicating with their investors, experts say, often preferring simply to try to fix the problems in their portfolio rather than explain themselves to their backers. But focusing only on the real estate left investors unhappy and in the dark.

"A lot of it was based on good intentions, but just a lack of experience in how to communicate bad news because things had been good for so long," Katz says. "Everyone has had problems with their portfolios. The GPs who will lose investors are the ones that didn't communicate well." Communication may be as important as location when it comes to running real estate investments, in other words.

> ***"When you invest, make sure you find a good spouse because the prenuptial agreement is not going to save your marriage."***
>
> ***— Anthony Messina, managing director, Westmont Hospitality Group***

"The types of managers that are really having issues haven't done a good enough job of communicating, either with transparency or frequency of communications," agrees Frammartino.

FOCUS ON INDIVIDUALS

GPs have a fiduciary duty to their LPs that is quite different from the role the partners might have in a joint venture, experts say. LPs want investment managers that are constantly thinking about how to serve their investors.

"When you're running a fund, you have to be committed," Katz says. "You wake up, and that's all you think about: How are you going to serve those investors, and the people that are relying on that for their pension benefits? It is just a very different level of commitment."

It may help to have "hurt money" invested alongside the deal. Many consultants still suggest that LPs seek out and invest with GPs that have significant amounts of their own money invested alongside or in any fund. The funds that have failed at big investment banks may have had a headline amount of house capital from the GP — but a figure that made little difference to the company overall.

Many consultants therefore suggest that niche GPs and fund managers may find it easier to raise capital now. Their executives often have a more personal interest in the fund, and there's less chance of being left with an "orphan team" after managers leave from a big investment bank, investment consultants say.

"If it's your only option and you've got a good percentage of your net worth and reputation vested in it, odds are you're going to stick around until the end of a fund," Frammartino says, adding that Townsend data suggests smaller, more-focused strategies have outperformed over time.

The global financial crisis has made it clear how important it is to pick the right investment partner. In a rising tide, everyone looks good, but — to paraphrase Warren Buffett — it's only when the tide goes out that we learn who has been swimming naked.

Anthony Messina has been on both sides of the negotiating table, as an LP investor and the head of global real estate acquisitions at Cadim, a subsidiary of Canada's largest pension fund, the Caisse de Dépot et Placement du Québec. He is now on the GP side, leading the fund-raising efforts at Westmont Hospitality Group, a global owner and operator of hotels, which is preparing to launch a second hospitality fund.

He says the most important lesson he has learned is that it is vital to know the people that you are dealing with rather than the reputation of the company alone. Developing a strong relationship with the investment manager is much more important than any legal wording that can be put into a partnership document.

"When you invest, make sure you find a good spouse because the prenuptial agreement is not going to save your marriage," Messina says.

The fine print of the investment agreements has done little to protect investors when a fund turns bad. Big names also have been of little protection. As reported by *The Wall Street Journal* during the past 18 months, investors discovered from the bankruptcy of Lehman Bros. that there was no protection from a major name.

Messina says investors may have been blinded by those Wall Street names, without realizing the full implications that the individuals who actually run the funds can easily move on. "Understand who you are investing with, not just the terms you are agreeing to," he cautions. When the market turns against you, "it is better to have a good GP who is a good investor who can change the outcome over time. A bad partner might make that investment very challenging."

It also is incumbent on LPs to consider the other LPs in a particular fund or investment, experts say. Any individual LP needs to make sure the other investors share similar goals and a similar timeframe on their investments, ensuring that if times do turn bad, investors will be able to agree on a shared course of action, rather than some trying to withdraw their investment while others want to remain for the long haul.

"LPs should not hesitate to question the suitability of fellow investors, their fit and culture, well before committing," Johnstone Kaiser says. "It isn't always easy — confidentiality can present a challenge — but seek out GPs who are willing to put you in touch with existing investors or other potential LPs. This is especially important for minority LPs who may never have the insights of a majority member with a seat on an investor representative committee."

Ted Leary's Top 2009 Lessons Learned (in no particular order)

1. Co-investment by a manager does not necessarily produce better performance.
2. When you underwrite an allocator, you need to understand their ability to underwrite and manage operators.
3. Alignments of interest structures often dissolve and even reverse when markets go bad.
4. Bigger is often "badder" when AUM reaches the tipping point where AUM revenue is more important to the manager than performance-based revenue.
5. Investors need to keep a close and continual watch on their investments — even in discretionary funds. "Trust, but verify!"
6. Investors need to have a "voice and even a vote" in higher-yield/risk strategies.
7. If a manager can't readily and easily describe its "risk management" process, it doesn't have one.
8. Beware of managers who want to go "outside their box."
9. Leverage doesn't make an investment a better investment — it simply increases the potential rewards and risks of that investment.
10. In the end, "Like politics, all real estate is local."

Bonus Lesson:

If you want to discover whether a manager is a "fiduciary," you need to look into their corporate "soul" — not just their numbers.

— Ted Leary, president, Crosswater Realty Advisors

THE BOTTOM LINE

LPs need to develop long-term relationships with the people managing their money. The one saving grace of the credit crunch is that it has produced the perfect situation for investors to get GPs to listen to them and provide the due-diligence information, fund structures and communication that they are likely to need.

"We're not a retail developer in Plano, Texas, borrowing from his S&L anymore," Leary says. "The world has changed, and we need to change with it." ❖

Alex Frew McMillan is a freelance writer based in Hong Kong.