

# THE INSTITUTIONAL REAL ESTATE LETTER

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## NORTH AMERICA

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Volume 24, Number 10

ISSN 1044-1662

November 2012

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## Prometheus Rising

### Though Stymied by Investors' Aversion to Risk, the Space Occupied by Emerging Managers Still Brims with Promise

by Mike Consol

*The salad days of real estate investing are long behind us. But that hasn't stopped emerging managers — loosely defined as firms with no more than \$750 million and three funds under management — from proliferating in recent years, even as the bar that investors have set for manager selection has gotten even higher. Few pension funds have established emerging manager programs because the cost is steep. Despite all of this, many of the people in and around the emerging manager business still get frothy about the topic.*

Let's start with a bottom-line question: Is now a good or bad time to be an emerging manager?

The answer depends on whether you're talking about the space or the individual firms that occupy the space. Emerging managers and the investment professionals who comprise their surrounding ecosystem are enthusiastic about emerging managers writ large. But individual emerging managers are in a mortal battle to win the precious few dollars available for operators of their scale, and to perform at a level that gives them the credibility required to raise a second fund.

A loyal cadre of repeat investors is a beautiful thing. Alas, with hundreds of emerging managers in a full-throated frenzy for limited

institutional dollars, loyalty is not easy to come by.

Enter the redoubtable Larissa Herczeg. She's about to put both sides of that equation to the test. Her pedigree includes managing funds at Credit Suisse, spearheading the emerging manager program at Franklin Templeton and, most recently, serving as director of real assets at Morgan Creek Capital, a firm that administers real estate emerging-manager programs for institutional investors. Now she is teaming up with an emerging manager, Chicago-based Oak Street Real Estate Capital, to build a new fund of real estate funds.

In effect, Herczeg is moving from the space to the firm level, from big to granular.

Herczeg is jumping into the fray because she's convinced the space for emerging managers who invest in real estate is about to expand momentarily. She makes the case that pension funds have 10 times the number of private-equity programs for emerging managers as they do for real estate. History shows that real estate tends to lag trends in private equity. That being the case, real estate's time likely has come.

If she's correct, there could be many more programs in the offing similar to those at Teacher Retirement System of Texas (TRS),

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## Prometheus Rising

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which has its own in-house emerging managers team, and the California Public Employees' Retirement System (CalPERS), which just committed to a \$200 million five-year program to be administered by Canyon Capital Realty Advisors.

But TRS and CalPERS are mammoth pension systems with assets of \$112 billion and \$235 billion, respectively. They have the hefty resources required to afford such ventures. Pensions of that magnitude are rare, which is why so few pensions plans have real estate flavored programs for emerging managers.

Take, for example, the medium-sized northeastern pension fund — that asked to remain anonymous — that is currently considering a real estate program for emerging managers, as a follow-on to a broader commitment to the emerging manager space it made seven years ago to private equities and fixed-income allocations. Though the pension fund is \$24 billion strong, its principal investment officer for real estate is concerned the pension cannot afford to play in that arena.

"With a relatively small allocation to the emerging manager real estate program, it's not as though we can expect a handful of \$5 million to \$10 million real estate deals to move the needle," the investment officer explains.

The other concern revolves around fees. For the amount of money that would be committed to the program — which will most likely not exceed \$100 million — the investment officer questions whether the cost of an outside program manager would be worth the five or six investments the pension could afford to make with emerging managers.

Still, the investment officer is continuing to explore the issue and expects to take a recommendation to the investment adviser

committee during the first quarter of next year.

Ted Leary, founder of Crosswater Realty Advisors, can sympathize with the dilemma the pension fund is facing down. Though he consulted with CalPERS in helping design its program, he has reservations about the value of emerging manager programs at smaller pension systems.

"I'm not sure the economics work," says Leary.

### FORMIDABLE NUMBERS

The current market for emerging managers is rough and tumble. A recent conference produced by Credit Suisse offered sobering arithmetic. During the past two years 302 North American emerging managers have been trying to raise capital. The results:

- Only 10 percent of them had a final close
- Another 16 percent raised some capital
- 74 percent were unable to raise any money

"These are staggering numbers," says Debbie Harmon, CEO of Artemis Real Estate Partners. Harmon is an emerging manager who has had significant success raising money, though it took almost 250 phone calls and meetings with investors to raise her target capital.

Scott McArtor, co-founder of Hawkeye Partners, also can count himself among the lucky. He and his team currently have \$915 million in assets under management, and the firm's clients include TRS, California State Teachers, and pension funds in North Carolina, Pennsylvania and Wisconsin, according to *Real Estate Alert*.

McArtor already has racked up successes that are the stuff of dreams for most of his peers. Despite that, one can hear in the tenor of McArtor's voice the formidability anyone faces in raising funds today.



Herczeg



McArtor

"The risk tolerance among pension plans has gone down because of the difficulties they've suffered over the last few years," he says.

One of the byproducts of risk avoidance is reflected in industry data cited by McArtor. It shows the top 25 real estate investment managers control 72 percent of investable dollars, and the top 10 firms control 51 percent.

"You have a lot of dollars in the hands of very few," says McArtor.

Meanwhile, emerging managers battle for a bit of the trickle down.

One of the people helping facilitate marriages between emerging managers and institutional investors is Nancy Lashine of Park Madison Partners. For every 100 deals she reviews perhaps five get consummated. She calls the hunt for new sources of capital from institutional investors "extremely challenging."

A shakeout and consolidation of the industry already has begun, Lashine says, but she does not expect the total number of emerging managers to shrink because adventurous new entrants are continuing to join their ranks.

### THE RATIONALE

With the difficulty and risk involved in doing business with emerging managers, one can understand why most institutional investors don't play in that league — even if they have the financial and staff horsepower to do so. Those that do invest the time and expense in emerging-manager programs are clear about their motives.

Let's start with alpha. Emerging managers, almost by definition, are engaged in value-added and opportunistic investment strategies that promise larger yields.

Then there's the singular focus of a firm with just one do-or-die fund on which to concentrate.

Marc Weidner, managing director of the global real estate group at Franklin Templeton, sums it up this way: "It can be good to have a manager with a single focus. That way, you sleep at night because you know the manager doesn't sleep at night thinking about your portfolio, rather than an overall



set of portfolios.”

Indeed, Franklin Templeton conducted an oft-referred-to study (albeit based on “persistent anecdotal evidence”) that concluded a firm’s maiden fund tends to outperform its second fund, and the second fund tends to outperform the third fund.

“Of course there are outliers to this,” Weidner acknowledges. “It’s not a universal rule, but it seems to be a trend.”

Leary doesn’t find the Franklin Templeton and similar studies convincing, though he says there might be something to be gained by the “younger, leaner, meaner, more creative” nature of small investment firms.

There are detriments to size. Lashine says large funds can lose their focus and ferocity when billions come under their purview, especially when they can live quite nicely off their management fees alone. Harmon adds that funds can become so large they reach a tipping point where the investors are, in essence, buying the market. In that case the fund loses the agility required to generate alpha.

Being a boutique firm also

affords the luxury of selecting a niche, says Thomas Mackell, author of *When the Good Pensions Go Away*, and former board chairman of the Federal Reserve Bank of Richmond.

“It’s really a function of bringing to the marketplace something that, perhaps, the other funds are not doing,” Mackell says.

Diversification is yet another goal sought by emerging manager programs. Large investment firms must invest money in large denominations for it to make internal economic sense. Emerging managers can target the kind of smaller niche plays that Mackell refers to.

Bob Sessa, director of real estate for the Employees Retirement System of Texas, has a relatively new emerging manager program administered by Morgan Creek Capital. Sessa says the program gives access to smaller size deals he would not otherwise see, as well as access to secondary and tertiary markets — such as San Antonio — that large

investment firms overlook because of their emphasis on gateway cities.

Identifying and investing with star talent is one of the chief objectives being pursued by Stuart Bernstein of TRS. Bernstein heads a three-person team focused solely on emerging managers. As an extension of the organization’s internal efforts, Bernstein made a \$200 million allocation to Peter Braffman at Credit Suisse. Braffman has a large team at his disposal that helps TRS identify the kind of emerging managers that fit its objectives. (See related story on this page.) TRS’s in-house team also makes some direct investments in emerging manager funds in the real estate space.

Among the emerging management firms TRS is doing business with are Pennybacker Capital, Hawkeye Partners, Integrated Capital and Meadow Partners.

Ken Fearn of Integrated Capital is an example of what TRS is looking for, Bernstein says. Fearn has a distinguished record in the hospitality acquisition and management consulting businesses. He decided to raise his own fund and do his own deals.

“Anytime you can have somebody who has successfully executed these kinds of investments in the



Bernstein

## Advice from a Gatekeeper



Braffman

Hundreds of emerging managers in North America are jostling to win attention from people the likes of Peter Braffman. As a director in the Customized Fund Investment Group at Credit Suisse, Braffman sifts through the performance metrics of hundreds of emerging managers annually to conduct due diligence and potentially invest in their funds on the client’s behalf.

Given that role, emerging managers might do well to take note of what he’s looking for while vetting their ranks. Braffman says he is searching for emerging managers with:

- A demonstrated track record. In other words, investment firms that have already proven they can find the right assets, add value to those assets, and divest them with prudent timing.
- A strategy that harmonizes with Credit Suisse’s

strategic outlook for geography and asset types.

- A strong team capable of managing and investing money and assets, as well as carrying out fiduciary and reporting responsibilities.

If you’re fortunate enough to get an in-person meeting with Braffman, it’s best to know the contretemps that knock the air out of his soufflé. Those would be:

- An investment team that cannot clearly define its strategy or its ability to add value.
- A track record that is not consistent with the client’s or manager’s strategy.
- An unwillingness or inability to be transparent.

Regarding this last point, Braffman explains: “Sometimes they don’t want to share information. If they won’t show me their business plan our interaction ends very quickly because they don’t have the right mindset to be a fiduciary.”

— Mike Consol



private sector and decides 'I want to be an entrepreneur,' that's something we certainly want to look at," Bernstein says.

Another example is Jeff Kaplan who runs Meadow Partners. Kaplan earned his professional stripes at Morgan Stanley and Westbrook Partners. He currently is raising capital for his second fund.

While Bernstein focuses much energy on the emerging managers he does business with, he says he expends even more energy on the emerging manager space.

"We have an emerging manager program because we're in the forever business," Bernstein says. "We're going to be doing this for decades and decades. The superstars of today are not necessarily the superstars 15 years from now, and most of them were not the superstars 15 years ago."

#### GIVING DILIGENCE ITS DUE

While there is no shortage of star talent among the roughly 350 emerging management firms operating in North America, there is something Leary calls the "needle in the haystack issue."

The amount of due diligence required to sort through the hundreds of firms pining to do business can be far too much work for a pension system's internal staff to handle.

"That's the biggest challenge that needs to be overcome in order to effectively reap the rewards of an effective emerging-manager program," says Weidner. "That means we're dealing with managers where there is a very long gestation period, a very long negotiation and due diligence phase before you invest."

That's why even the largest pensions hire organizations such as Franklin Templeton, Morgan Creek, Credit Suisse and Park Madison Partners to vet their ranks.

Lashine says the tricky part about due diligence is ensuring the emerging manager truly understands what it means to be a fiduciary, which comes with a broad set of responsibilities and concerns.

Leary questions whether an effective due diligence process for assessing emerging managers

even exists. "How do you vet a creative idea? How do you vet a creative team?"

As an example, the head of an emerging management firm comes into a meeting brandishing a book of business that touts the investment deals and lavish returns he or she claims. And Leary shoots back, "What do you mean your deals? Weren't they your company's deals? Weren't they the deals you did with your colleagues? Weren't they the deals you did that were approved by your investment committee, or maybe even your client? So why do I believe that if you leave your previous firm you're going to be able to reproduce the same results? Particularly if you have a new idea that hasn't really been tested."



Harmon

#### LITTLE FISH, BIG POND

Obviously, some emerging managers are clearing the due-diligence hurdles, even if it takes extraordinary measures to gain an investor's confidence and break out of the pack.

Harmon, of Artemis Real Estate Partners, stacked the odds in her favor by throwing more than a little skin in the game. She and her team invested \$50 million in their first fund "from day one."

"We were prepared to be one-third of the capital of our own fund," Harmon says. "Most general partner capital investment in larger funds are 1 percent to 5 percent of the total equity raised, and typically it is invested over the three-year investment cycle."

Besides offering up her own financial hide, Harmon differentiated her firm by being willing to close her fund at only \$150 million, and imposed a \$500 million cap on it. Artemis exceeded its \$300 million target closing with investor commitments totaling \$436 million.

Harmon and Artemis scored big with a \$300 million separate account from the \$146.9 billion

New York State Common Retirement Fund. In addition, Artemis has accumulated what Harmon describes as a diversified investor base that includes corporate, public and international pension funds, wealth advisory firms, family offices and high-net-worth individuals.

McArtor, of Hawkeye Partners, says his firm's strategy is to provide seed capital to talented managers, then help them establish a track record of investing and training them on the processes required to handle institutional money.

The differentiator at Integrated Capital is that it occupied the hotel niche and assembled a team with more than 50 years of combined hospitality and real estate investment experience in underwriting, development, financing, asset management and dispositions.

#### HELLO, IT'S ME

Of course, it doesn't hurt to have friends in high places.

"One of the things I've learned in working with emerging managers is that it's difficult to succeed on your own," Herczeg says, "It's so important to have people who are supportive."

Herczeg is undoubtedly banking the new fund of funds venture at Oak Street Real Estate Capital on the client relationships she developed at Credit Suisse, Franklin Templeton and Morgan Creek Capital, as well as the in-house professional relationships she forged.

Braffman of Credit Suisse is a personal friend, as is former Morgan Creek Capital managing director Brad Briner, who now directs real asset investing for Willett Advisors. She also has a professional relationship with Franklin Templeton's Weidner. They know Herczeg has the chops investors are pursuing.

So while Herczeg believes the emerging-manager space is poised to expand momentarily, she probably isn't fretting about getting lost in space. ♦

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*Mike Consol* is editor of *The Institutional Real Estate Letter — North America*.

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