THE INSTITUTIONAL REAL ESTATE LETTER
NORTH AMERICA

Volume 24, Number 9 ISSN 1044-1662 October 2012

FEATURES

A Long, Strange Ride
Our editorial board discusses the sands of change on the California coast.
By Geoffrey Dohrmann 3

Continental Drift
Offshore investing takes a holiday for some U.S. institutional investors.
By Mike Consol 31

Enter the Dragon
Is our fear of China and its surging economy really worth the sweat?
By Susan Fornoff 39

Shop Talk
Nils Kok of the Global Real Estate Sustainability Benchmark talks green business.
With Mike Consol 47

Get Real
The hype about real assets might be hotter than their payoff.
By Brad Berton 53

Warehouse Wins the Wars
Internet commerce has changed the balance of power between the warehouse and retail sectors.
By Marc Louargand 59

The Big Get Even Bigger
Investment managers report assets under management are on the rise.
By Larry Gray 73

DEPARTMENTS

Market Perspective	6
People	16
Investment News	19
Search Activity Table	20
Investment Guide International	79
Market Focus: Chicago	86
Recent Transactions	87
REIT Roundup	89
Capital Markets Snapshot	90
Market Pulse	94

Side Effects

In the Recession's Aftermath, Investors and Investment Managers Recalibrate How to Deal with Real Estate — and One Another

by Steve Bergsman

The long-term effects of the Great Recession on institutional investor interest in real estate have yet to be surmised. At this transition point in the recovery, what is happening is a consistent flow of capital to the asset class (indicating its growing durability among fund managers); slight changes of focus to value-added and global investing; consolidation of investments to a smaller number of managers; and pressure on managers to strengthen governance, increase transparency, and offer flexibility in their fee structures.

By some measures, U.S. real estate markets began to come down from the top of the mountain around 2006, but it took the subprime mortgage crisis of 2007 to push the investment sector over a cliff.

Real estate has deleveraged significantly over the past six years, and when that happens you get a freefall, observes Michael Torres, a principal and portfolio manager for Adelante Capital Management in Oakland, Calif. "The volatility was extreme, which is what happens when markets lose confidence," notes Torres

Now, six years later, the dust has cleared and investors are gearing up for another ascent.

While the sector wasn't abandoned by institutional investors during the worst years of the recession when property values were plummeting, slight tectonic shifts have occurred. Separate accounts have become popular again; in the commingled fund world the flight to safety, or core, is easing; and on the business side of the ledger, there's pressure to change both fee structures and approaches to transparency.

Otherwise, the clouds have moved away and the sun again shines down on the world's property markets.

Or, as Torres says, "The deleveraging of real estate that we saw not only in the United States but around the globe has already taken place."

Indeed, the Great Recession ended midyear 2009, and in regard to the real estate sector recovery has been slow but steady since then.

The Pension Real Estate Association (PREA) recently interviewed its members as to the asset class. Its survey showed 2009 real estate holdings (private and public) were $198 billion (for the reporting group), or 9.4 percent of investors' total assets. By 2010, total real estate holdings were $206 billion or 8.9 percent of total assets. In 2011, holdings jumped to $241 billion, 10.5 percent of the total.

Let's look at other recent numbers.

Every year, Kingsley Associates, San Francisco, works with

Continued on page 10

Side Effects

Continued from page 1

Institutional Real Estate, Inc. on a plan sponsor survey. That report shows new capital flows to real estate peaked in 2007 at $71 billion and then plummeted to $18 billion in 2009. Since then, the recovery has moved unsteadily forward with an expected $36 billion in new capital flows to real estate in 2012, up 17 percent from the year before.

Interestingly, the same survey shows investors' real estate targets as a percent of total assets haven't changed much over the past four years, hovering in a narrow band around 10 percent.

What should we take away from this scramble of numbers? Perhaps that real estate as an investment sector remains a constant.

"Despite the collapse of real estate over several years, including massive losses and disastrous returns, investors have not cooled on the sector," says Ted Leary, president of Crosswater Realty Advisors, Los Angeles. "They are still allocating a reasonable percentage of their portfolio to real estate. That's a sign the market has matured and real estate is being treated like other large asset classes that have ups and downs."

Or, as Roy Schneiderman, founding principal of Bard Consulting in San Francisco, suggests, "Real estate has proven as stable as any other asset class."

NEW DIRECTIONS, OR NOT

During the heart of the recession there was a flight to safety, which in terms of real estate investments meant more interest in core programs with big, stable real estate that throws off a consistent return.

However, a wholesale stampede to core didn't actually happen because of the vast sums of capital involved.

Changing the directions of real estate portfolios is like moving a battleship, Schneiderman comments. "No plan sponsor has gotten there yet. The people who are shifting to core are still shifting to core. However, the frenzied rush to core has become more well-paced; the velocity has decreased."

When the market goes into the tank, there is a queue to get out of real estate, and when the market is hot there is a queue to get in.

At Cleveland-based ORG Portfolio Management, Ed Schwartz, a principal with the company, says there hasn't been much alteration in the direction of investment. "We haven't done much in the area of change," he says. "We've been consistent, about 50–60 percent in core, but we define it differently than others. We look at risk of the investment. A commercial mortgage fund could be core depending on the risk attributes — no mezzanine, lower debt, and 30 percent or more capital in front of investor capital to protect them in a down market."

When the market goes into the tank, there is a queue to get out of real estate, and when the market is hot there is a queue to get in, says Leary.

Then there is core, which was a good compromise for many investors.

"Open-ended funds tend to be core, and they are pretty healthy," says Leary. "There are a half-dozen, open-ended funds that are quite popular and doing well, throwing off solid cash flow."

Traditional tax-exempt institutions, such as pension funds, have emphasized core real estate investments, with about 50 percent of portfolios targeted to those assets, says Jim Woidat, a principal with Kingsley Associates.

As expected, "during the recession there was a flight to core, with most investors overweighting as real estate values were collapsing," Woidat reports.

In 2009, about 44.3 percent of total institutional investor real estate assets were targeted to core/core-plus, Institutional Real Estate Inc. reports, and that number continued to rise during the next couple of years, to 46.8 percent in 2010 and finally peaking at 51.9 percent in 2011.

Recently, Woidat says, "we have seen a growing intention to allocate to higher-yielding strategies such as opportunistic and value-added funds. For 2012, investors told us they plan to allocate about 60 percent of their capital allocations to higher yielding strategies."

According to the 2012 Institutional Real Estate, Inc. survey, institutional investors are targeting 45.4 percent of assets to core, down sharply from 51.9 percent the year before.

Although only REIT allocations showed declining numbers in 2012 over 2011 — 8.7 percent compared with 9.8 percent — a second-quarter scorecard by Adelante Capital Management reports 51 percent of REITs exceeded earnings expectations, 36 percent fell in line with expectations; and 12 percent missed expectations.

The Adelante Capital report notes: "REITs performed better than Street consensus, though it should be noted many of the 'beats' were small or came from one-time items. Stripping out the noise in the numbers, most of the reporting companies have come in line with estimates, which gives an indication that the operating business is running as planned."

As for foreign investment, Claiborne Johnston, a senior director and client portfolio manager with Invesco Real Estate in New York, says he sees a number of institutional investors considering a global investment program.

"A number of our clients who have historically focused on the United States are now looking at global opportunities," he says. "Some of the Asian markets, for example, present interesting opportunities for value-add and core investors."

Sally Haskins, senior vice president in Callan Associates' Real Asset Consulting Group, Chicago, also has a number of clients going global.

"In terms of the allocation, you would have seen at the end of 2009 and 2010 and even into 2011 predominantly core weighted," she says. "Now we have shifted to higher returning vehicles, and not only U.S. but global as well. We

have done an increasing amount of work outside of the United States, a distinct change from prior years. Core commitments continue but tend to be follow-on allocations."

She adds, "Our investors have an appetite for distressed, and there is distress in lots of places in the world. There is also recovery and growth, especially in markets like China. Our global interest has been more weighted to Asia."

Still, the number of plan sponsors with visions of Tokyo or Paris remains small, especially with Europe in turmoil. Conversely, foreign institutional investors are more sanguine about U.S. real estate, especially core.

"As a result of the turmoil and future uncertainty around the euro zone financial crisis, foreign capital is interested in buying U.S. core assets and are being flexible in the timeframe when underwriting their exit strategies," says Mark Grinis, Global Real Estate Funds Leader at Ernst & Young in New York.

To which he adds, "There is a finite amount of core, high-profile real estate in the world and key gateway cities in the United States, such as New York, Washington, D.C., and San Francisco, as well as London and Paris. With Europe causing concern — with the exception of Paris, the United States and London are going to get the capital."

MOVING PIECES

After the performance failure of a number of real estate investment funds during the Great Recession, there has been an expected consolidation of capital in a smaller number of programs.

"In this difficult environment, the investment community evaluated the performance of all funds and all managers and made assessments," says Grinis. "Plan sponsors have to go in front of their boards to make recommendations where to deploy capital. The manager that outperformed the market and was forthcoming with open and honest dialogue is more likely to get future allocations. Plan sponsors have consolidated their investments."

Investors have shifted to very established managers, says Greg MacKinnon, director of research for PREA. "Some very large funds have been able to raise a lot of money recently, and the mid-sized managers are really having difficulty closing funds. The movement has been first to core and then to larger, established managers."

Will smaller funds survive? Apparently, there is still a need for the other guys.

"Some capital is flowing to the smaller, newer core funds in part due to the long investor allocation queues that the larger funds are experiencing. Some investors prefer not to wait on the sidelines," says Allison Yager, an Atlanta-based principal and global leader in Mercer's real estate practice.

In the core open-end fund universe, capital is not rotating out of the more poorly performing funds very quickly because of the long wait to access other funds, Haskins says. "In the interim, people are keeping money managers that are lower quality from a performance or organization perspective or not a strategic fit. But it's not necessarily long-term, they just can't get into the other funds right away, and they want to earn a real estate return while they wait."

Initially, fund managers were given a bit of a break because of the Great Recession. Such allowances have their limits, however. Those managers who continued investing when the writing on the wall indicated things were overheating have since taken it on the chin.

"We analyze the investing pattern of an investment manager against the market cycle over its history," Yager says. "If a noncore manager raised a 2006 vintage fund and only invested 20–25 percent by late 2007 but continued to invest the remaining capital before the end of 2008, we take this into account in determining our view of the firm's ability to analyze and interpret market events."

There is a more cynical way to look at this phenomenon.

"The people who were successful are getting monies, and the people who were unsuccessful sometimes just moved to other companies," says Schneiderman. "Some managers had issues and found it difficult to raise money. They lost people or folded up, and those people just moved around to another fund."

It would seem plan sponsors just needed to be even more circumspect in regard to investment managers.

"The bar that investors have set with respect to manager selection has only gotten higher since the downturn," asserts Johnston. "Investors are looking for managers who really distinguished themselves during the downturn with respect to not just performance but also transparency, communication and fiduciary responsibility."

SEPARATE ACCOUNTS

Another trending shift in the plan sponsor world is a movement back to separate account investing, especially by the larger pension funds.

Years ago, when the real estate investment business for plan sponsors began to take off, it was a separate account world, Leary recalls. "Then it morphed into funds starting in the 1990s. Now, it has settled down into two different worlds."

He continues, "The pension plans have cooled on making large investments in commingled funds because of the lack of control. In a separate account, you negotiate directly with the manager, negotiate terms, and if things go bad you have some control."

Sovereign wealth funds also like separate accounts, says Grinis. "They like the control and the ability to tailor toward specific objectives, while being able to tap the expertise of established real estate investment managers."

Investments in separate accounts really differ by investor size.

"When we look at our investment survey, on average last year, 70 percent of new capital was expected to go to pooled or commingled funds," Woidat reports. "Yet, when you look at it on a more weighted average by investor size, 64 percent of new capital was going to separate accounts. This is driven by a select group of large investors looking for more control over their portfolios, versus the typical institution looking to take advantage of the efficiencies in investing in funds."

There is no question the separate account structure has seen a

resurgence in popularity, says Johnston, "but you have to be careful as to whether or not those structures make the most sense for a plan. That depends on scale and size of a particular mandate and the actionable opportunities that exist for a particular strategy."

TRANSPARENCY

So, which managers will be getting new capital in the future? It's not just the ones that were more successful during the downturn, it also will be those that were perceived to be less obstinate managers when everyone needed more flexibility.

"Investors are expecting more transparency from managers, and that is driving a lot of change. Managers who specialize in structures such as separate accounts should continue to benefit from this trend toward shared governance, increased transparency and communication with clients," says Johnston.

MacKinnon adds, "What we found with managers coming back to the market to raise capital is those managers that tried to deal as fairly as possible with investors and were as open as possible are having it a lot easier."

In the investment business, sometimes things don't work out the way managers thought they would. Investors understand that, says MacKinnon. "As long as the managers are being open, transparent and showing how they are trying to move forward, when the time comes to raise capital, they will be more likely to be able to get it."

How do you get more transparency from fund managers? It's an issue a lot of plan sponsors struggle with.

"It starts with picking fund managers that believe in transparency and will act upon it, as opposed to picking fund managers who defer to fund documentation and say 'this is what you will get and nothing more,' " Schneiderman says. "It's not a bad idea to negotiate more transparent language into the fund documents, but you really win this battle by picking the right fund managers, not by negotiating the right deal."

UNFEEDING FEES

Perhaps the area of fund management that has gotten the most scrutiny during the Great Recession years and continuing through today is fees. While there has been a lot of noise, underneath the din not much has changed overall, although bits and pieces of various fee structures have been altered due to investor discontent.

"Investors are always looking to reduce fees, but they are also a logical bunch who understand the management fee cannot be reduced to zero because fund managers need to charge fees to keep doors open," says MacKinnon.

The fee situation has, in some way, ended up in a forced equilibrium.

MacKinnon explains: "Smaller funds are not being pressured to reduce management fees because they are needed to stay in business. Large managers could reduce fees, but there is not as much pressure to do so because of the demand to be in larger funds."

In July, the Institutional Investor Sentiment Survey issued by Private Equity International reported:

- 90 percent of limited partners believe management fees should be reduced following the conclusion of a fund's investment period, and 64 percent of LP respondents believe they should receive a fee break as an early investor in a fund.
- More than 35 percent of institutional investors believe fund managers should charge a 1.5 percent management fee in order for them to consider making an investment in a private equity fund. Almost half of survey respondents cited high management fees as sufficient reasons to not commit to a fund manager.

Grinis says LPs have taken the view, "We want you to get paid to maintain best-in-class operations, but above and beyond that we want the proper alignment and incentives in place."

The LP community saw managers were getting wealthy on asset management fees, says Leary, and the consensus now is the management fee should cover overhead and a small profit. Or, as one of Leary's clients said to an investment manager, "I don't mind you having the house in Aspen, but I want you to pay for it out of your performance fees, not your base fees."

A particular client focus has been on catch-up provisions in value-added and other total return vehicles, where these provisions are either being tweaked or eliminated in exchange for lower hurdles.

These total return structures traditionally have included a catch-up mechanism, Johnston explains. "After the investor receives a return of capital plus a return on capital, managers often receive a disproportionate share of the profit until they have received 20 percent of the total profits. Recently, these catch-up provisions have been a particular focus for many investors seeking to improve alignment with their managers. While a number of managers have adopted a higher preferred return or even a second hurdle before implementing a catch up, other managers have eliminated the catch-up provision entirely in exchange for a lower preferred return."

Haskins of Callan Associates says when representing clients she often focuses on governance and certain elements of the fee structure: reducing the threshold required for investors to effectuate change, such as the GP kick-out provision (replacing the GP); switching from deal-by-deal to a portfolio distribution structure; and reducing the catch-up.

"We focus on those areas where we might find potential misalignment between client and manager," says Haskins.

To which Schneiderman concludes, "Clients are always interested in reducing fees and there are periods of time where the LPs have more leverage. This might be one of those periods, but everybody recognizes the pendulum swings both ways and what you see is a cyclical, not structural, change." ❖