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REAL ESTATE COMPENSATION AND INCENTIVES

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Q&A: An adviser's take on how fees and incentives have evolved

Ted Leary of Crosswater Realty Advisors talks to PERE's Wanching Leong about how managers and investors have to be more thoughtful about tailoring the fee structure to match the relevant investment strategy if they want to achieve sustainable results

PERE: How and why do fees drive fund manager conduct?

Ted Leary: Fees are huge drivers of conduct and it is one of the dynamics that the investor community and fund manager community have not focused on enough. Fees create a road map to conduct; you're asking people to beat a hurdle – you won't get paid an incentive fee until you've achieved or exceeded a certain hurdle. People are going to take risks that are tremendous or often inappropriate to beat those hurdles. I think one of the things that I saw in my review of managers over the last few years is that fees can drive how managers behave and it has not always been a happy story.

PERE: Which specific issues have contributed to this unhappy outcome?

TL: Two different dynamics happened in the last cycle. First, for the managers that I view as more realistic, maybe even cautious, about the market that was seriously getting overheated, I feared they were losing business. The cautious manager says, 'I could get a 12 [percent return] for a value-added investment'. Someone else says, 'I can get 15 [percent]'. Well, the client then gives the money to the guy who says they can get 15 [percent]. To get a 15 [percent] return means you have to take greater risks, maybe go to a secondary market or put more leverage on a property. That then causes the more cautious guy to say, 'I'm not getting my fair share of allocations so I better say to LPs I can get 15 [percent]'. That begins a vicious cycle where managers were overpromising results that they can only achieve by taking, in my personal opinion, undue risks.

Secondly, I don't think most of the managers understood the level of risks they were taking. I think they were oblivious to it. I think they believed their own propaganda. And so you had a steady escalation of promises of returns in a market that was getting overheated, overpriced and overleveraged. I think that conduct really goes back to the incentive fee structure that the investors and the consultants imposed on the business. This was a problem created by the investors and the consultants. The managers went along for the ride.

PERE: Can you elaborate on how the investors and the consultants created this problem?

TL: The LPs were looking for great returns out of real estate during this past cycle. Total returns means current yield plus a pop at the end so they get a higher IRR. They

then said, 'To do this we need managers that can deliver a higher IRR'. It goes both ways; they feed on each other. The managers come in and sell their funds. They say, 'I can deliver 18 [percent return]'. The LPs say, 'Most of the guys I talk to say it's a 13-14 [percent return] market'. The manager says, 'But I'm better. To prove I can give you 18 [percent], I'll give you a higher hurdle than the other managers'. The consultants don't want to say to the LP, 'I think you ought to choose a manager who is promising lower returns'. That's just not the way this business works. I think much of the blame on this past cycle is on the LP and the consultant side who weren't doing their jobs or able to say, 'Whoa Nelly, this is going out of hand. We should stop chasing yield, we should chase stability and cash flow and dependability'. But they didn't. And they paid the price for it.

PERE: Can you say which type of LPs were most guilty?

TL: It was across the board. It was the herd instinct run amok.

PERE: You were an early adopter of incentive fees back in the 1980s. Can you cast your mind back and discuss what fee structures were like back then?

TL: When I got into this business in 1989 it was largely a core business and the fees were based on assets under management and on a longer-term hold. There weren't a lot of fee structures in the late 1980s that were incentive-based. When we got into the business we said, 'We're willing to accept smaller asset management fees than the market, but we want a piece of the upside, if we create value'. We at Lowe Enterprises Investment Management were one of the first players to do that.

A lot of my friends in the business said that I was nuts. They said, 'Why do you want to give up a safer fee – that's the asset management fee – in exchange for a performance fee?' Because I think we're good at performance. I wasn't the only one, but I was an early advocate of that philosophy of getting a bonus based on performance.

A good example: what is core? Core is long-term, dependable cash flow. To use a baseball analogy, you want people to hit singles and an occasional double. Fund managers came in and said, 'I can get a higher return from core than other core players can'. They got incentive fees to create higher returns and so they basically changed the definition of core by taking on bigger risks and putting on more leverage. By doing this, they drew every side of the investor, the consultant and the manager into competing for yield and therefore created incentive fee programmes that rewarded yield and distorted the definition of core. Core used to be no leverage. And now core is no more than 50 to 60 percent leverage. This was all driven by fees.

I don't believe you should have incentive fees on a core programme because that distorts the goal of core investing which is steady, reliable cash flow. But that is what we did – we incentivised yield in core programmes and the business got into trouble.

PERE: In the past couple of years, when you said that the market got overheated, did this just apply to core or did it extend to value-added and opportunistic?

TL: It went across the board. It was everybody and it went out of control. Suddenly if you were going to get a 10 [percent return] on core instead of eight, you have to go even higher for value-added and you have to go even higher again for opportunistic. Therefore, to compete for the money, it just didn't pay to sell a conservative programme. Fund managers wouldn't get money because the LPs and the consultants were enticed by the siren song of yield.

One thing that happened when the market started to implode in '07 and '08 was there was such reluctance to take write-downs even when it was clear write-downs were deserved. They didn't do it because they were going to lose asset management fees – or even worse, get terminated.

PERE: Have management fees also become distorted in the same way that happened to incentive fees?

TL: I think fees are generally coming down because the managers have disappointed clients. It was clear that people were getting overly high base or asset management fees. As one of my LP clients said, 'I don't mind you [fund managers] owning a house in Aspen, but pay for it out of your performance fees and not your base fees'. What was happening was AUM fees became highly, highly profitable, particularly for the funds where managers had raised Funds II, III and IV. By the time you came to Fund II, III and IV and you had the same cost structure, the managers were just making an enormous amount of money. And these are a drag on ultimate performance. If the fees are too high, managers have to really prove themselves on performance and when performance deteriorates, the fees have an even bigger drag on them.

PERE: Should firms make a substantial profit on asset management fees?

TL: I don't personally think so. Back in 1989, that was not the way I designed my fee structure. I said I'm not going to starve, I'd like to make a reasonable profit on my asset management effort; I'm not in the charity business. But I want to earn my entrepreneurial return by producing entrepreneurial results.

PERE: Do you think there should be a difference for fees in terms of size of fund? The fees for small funds may not cover operational costs, but there could be a substantial profit to be made from asset management fees for large fund managers.

TL: I don't buy this – small fee, smaller cost structure. However, I do think the managers who were able to raise vast amounts of money and to keep their cost structure pretty stable, by the time they raised their second, third and fourth funds, their base fees were pretty much pure profit. Who do you blame that? Who should fix that? The investor and the consultant communities.

The managers are always going to ask for more money; that just goes with the DNA of the managers. But I think fees are coming down. There is pushback on high asset management fees and the LP community has learned a lot in the past five years. It's been a painful experience. I'm not sure the consultant community has learned a lot. People think there is a simple and easy answer to this but there isn't. It's just common sense that if you create a distorting fee incentive structure, you're going to get warped results. It's not rocket science.

PERE: You say that LPs have been the problem. How much can they rein in GP conduct?

TL: LPs are being marketed to; they're not marketing to the managers. There's no fund that's so good that there are LPs desperately hammering on the door to get in. There's a thought process that you have in private equity and venture capital that if I haggle I won't get in. But I don't think that's true in real estate. Real estate funds are still sold heavily by the GPs.

What is happening is that the big state employee funds in the US are starting to negotiate for more reasonable terms. A small LP putting $25 million in a commingled fund doesn't have a lot of leverage, but someone who's putting in $200 million has a lot of leverage on fees. It is happening. It's going to be hard because a lot of my friends who are managers are saying, 'We're going to get killed because the fees are coming down'. They're not going to get killed. If they work at a good firm and they run their business right, a certain level of asset management fees should be quite attractive. The key is to get the balance right, the balance between asset management fees and performance fees.

PERE: What is the right balance between management and performance fees? You say that fees are coming down, to what level?

TL: It's all over the place. But the idea of paying 150 basis points is just bizarre. It's clear to me that managers can run the asset management side of the business for south of 100 basis points or even much lower if it is a core programme. A more entrepreneurial programme like high value-added is more people-intensive than a core programme, so it probably warrants somewhat higher fees.

The other thing with incentive fees is where to set the hurdle. If you set the hurdle too low then managers are making money without really performing or doing anything extraordinary. If you set the hurdle too high, managers start taking undue risks. The LP herd gets fixed on a single number and the consultants get fixed on a single number. Every programme should have a bespoke programme within a range. In other words, investing in hotels is different from investing in fully leased industrial properties and should have a different fee structure. It's when they get into one size fits all or off the rack fee structures then trouble starts and fees and conduct get distorted. When conduct is distorted, performance is distorted and it is rarely to the benefit of the investor.

PERE: Should there be different fees for core versus value-added versus opportunistic?

TL: Absolutely. For core, you should have no or very limited incentive fees. For value-added you should have a little more incentive fees and opportunistic funds should have healthy, heavily back-ended incentive fees.

Then you get into the issue of when to pay incentive fees. In the last cycle, managers got paid incentive fees either on an asset basis in the mid-term such as three or four years out, or they got paid big incentive fees at the top of the market and then they lost their investors' money in the second half of the market, but they didn't reach back. So the manager made a lot of money, bought the famous house in Aspen and the investor lost money.

There has been a natural reaction these past few years for LPs to be punitive on fees. That doesn't get you anywhere because that just drives the best managers away. Both managers and investors have to be more thoughtful about tailoring the fee structure to match the strategy.

PERE: How long should managers wait for incentive fees to be paid?

TL: That is an interesting issue. The problem is the people who have the boots on the ground tend to be in their 30s to 40s. They have kids, they're buying a house, they're trying to build up some net worth. For a 30-year old to wait eight years to get a substantial bonus for good work is very hard. There needs to be a balance.

What happened in this last round was it was clear because of the market going down and performance was declining or mediocre, there were no incentive fees coming. There was no pot at the end of the eight-year rainbow. People bailed or didn't work very hard.

I'm not opposed personally to paying people midstream, but there has to be some enforceable clawback device. That's a great concept, but hard to pull off.

PERE: Surely lots of funds contain clawback clauses?

TL: They have them, but there's a reticence by the LPs to enforce clawbacks. I personally believe if you go out a long time, seven-plus years, you probably need to have some interim payment. You don't have to give 100 percent, but you need to give something particularly to the younger staff. Probably not to the bosses.

PERE: Can you explain why LPs are sometimes reticent to enforce clawbacks?

TL: It's just in their DNA. Maybe after this disastrous cycle they'll be less reticent. I think they're better than they used to be on that issue, but they're not probably as tough as they should be. My contracts used to have clawbacks and I used to get midterm payments. Or I would get paid a fraction of my incentive fee and with the remainder put in an escrow account that was at risk if I didn't continue to perform well. I was perfectly

fine with that. I took the view that I shouldn't earn a lot of money if eventually the whole programme is going to lose money or doesn't meet my total performance standards.

PERE: What are managers doing to correct or change the structures they have been offering LPs?

TL: I see no evidence of that. They're still looking for high fees. It's just in their DNA to optimise their profits. I don't blame them. If you look at the corrector in this it's the LP and consultant community.

PERE: Does manager co-investment really matter?

TL: No. There's zero evidence that manager co-investment produces better returns. It makes the LPs and the consultants happy that at least if the manager has co-investment and the LPs lose money, the GP loses some money. That's different from saying co-investment produces better results. There's no empirical evidence that can show that co-investment produces better returns. It just isn't there.

More importantly, what happened with the last cycle is so much co-investment, particularly with the Wall Street funds, wasn't personal co-investment but house money. One change that's happening is the investors who still want co-investment want personal, not house, dollars put in. By the way, not everyone wants co-investment: some people think it can distort things; it's not a universally held view by any stretch of the imagination; there are many different views within the LP community. That's a big change. If you believe that at least they're going to be hurt, you want the people to be hurt because it's a people business, not an institution business.

A lot of people like co-investment but I say, 'Show me the evidence'. They all say, 'We can't but we feel...' It's one of my hot-button issues.

PERE: Is there any correlation between fee structures and actual results?

TL: No. In many ways, the results you see from the last three to four years are that the managers who behaved like true fiduciaries, who consistently acted in the best interest of their client, tended to have the best results. That's because they saw the market overheating, they started to back off, they started to deleverage, they started to stop investing, they started to sell holdings and trim their portfolios and as a result they had better results. The managers who were just driven to pump out the money because of fee structures usually had bad results. So it really comes down to human nature and to specific fee structures because I know of managers who had very aggressive fee structures who behaved well, and other managers with very aggressive fee structures who behaved badly.

PERE: What incentives do managers have to structure their fees correctly?

TL: They want to do the right thing; that's why they're called fiduciaries. And people who treat clients well tend to have a long shelf life. This is a cyclical business – we're

going to go through another crash in five to seven years. Every time we have a crash managers disappear and jobs are lost. If you look at people who treat clients well, they tend to have a long life in the business. There are a lot of funds out there that are not raising money because LPs are disappointed in their economic performance and, most particularly, in their personal performance.

PERE: Do you think that LPs are now punishing funds that are not thoughtfully structuring their fees?

TL: I'm not sure I would use the word 'punishing'. I would say I am hopeful that the LP community is being more thoughtful about who to give money to and how to structure fees with the people they are giving money to. You can't go through a horrific period like the one we just experienced and not have some pain on the manager side of the business. They're the ones who invested the money. There's always a shakeout in any business after a horrific period of time. There will be this time and there should be this time. The managers who performed badly shouldn't continue to get money.

PERE: What are your thoughts on fees for separate accounts?

TL: I don't think fees for separate accounts should be much different from fees for funds. In separate accounts you tend to have lower fees because a separate account is usually funded by a larger institution that may be more sophisticated than a smaller institution and a larger institution has more leverage in establishing a rational fee structure; a LP putting $250 million in a separate account is going to have more leverage with a manager on fee negotiations than a small fund putting $25 million into a pool. But it not just fee leverage that is driving the move to separate accounts. The investor has much more control in a separate account.

PERE: Should managers be compensated based on benchmarks?

TL: You have the ODCE for core and NCREIF for value-added. If you pick the wrong benchmark, somebody is probably going to lose, either the LP or the GP. I was never keen on that. I was always saying, 'What do you want from real estate over a seven-year period?' I was a very early player at Lowe in the hotel business and at that point there were hardly any hotels in the NCREIF pool. They begged us to join NCREIF and when we joined, we tripled the hotel allocation in NCREIF. It wasn't a good benchmark for our particular strategy.

I would personally like to have a bespoke benchmark for different real estate strategies. That's hard to do so everybody especially on the LP side reverts back to some index. □

Theodore 'Ted' Leary is the founder and president of Crosswater Realty Advisors, an international real estate workout advisory firm. Ted and his fellow 'senior advisors' are currently engaged, on behalf of major institutional investors, in workouts and organisational restructurings in the US, Europe, Brazil and China.

Prior to founding Crosswater, he served as the chairman of Lowe Enterprises Investment Management, LLC, the institutional advisory arm of Lowe Enterprises. He had been with Lowe for 22 years. Ted began his real estate career in 1975 on highly complex workout assignments for major financial institutions. In that role, he resolved a wide variety of property problems in the US, Canada, France and Puerto Rico.

Ted is an acknowledged industry leader having served on the boards of directors of the Pension Real Estate Association, the National Association of Real Estate Investment Managers, the Association of Foreign Investors in Real Estate and the Real Estate Capital Recovery Association. He was honoured, in October 2005, with the prestigious 'Sponsors' Award' by The UCLA Real Estate Finance and Investment Conference for his significant contributions to the real estate investment industry.

Before entering the real estate business, Ted worked in the United States Senate as the Chief of Staff to US Senator Abraham Ribicoff.

Ted is a graduate of Harvard College (BA, *cum laude*) and George Washington University Law School (JD, *cum laude*).