Communication breakdown

Consultants and independent advisors are proposing their own solutions to the lack of communication among limited partners and their managers.

By Katherine Bucaccio

A panel at PERE's Global Investor Forum in Los Angeles: participants discussed LP-GP relations

In the wake of the global financial crisis, many real estate investors reevaluated their investment decisions and re-assessed their relationships with fund managers. Hoping to prevent some of the bad behaviors leading to the crisis, limited partners began communicating more frequently, both with managers and with other LPs, in order to gather strength in numbers and effect change.

However, consultants and independent advisors agree that, as the real estate market has become a stronger and safer place, their clients are communicating less across the board and tools like limited partner advisory committees have become less effective.

"In the aftermath of the crisis, everyone was getting together all the time because everyone was in crisis mode," comments Dan Krivinskas, senior consultant and director of real estate consulting at Portland-based consulting firm RVK. "Now, not as much."

Oftentimes, it is up to consultants and independent advisors to give both LPs and GPs the push they need to communicate more often and more openly. Now, many of these intermediaries are calling for changes in the behavior of both parties in order to bridge the communication gap – a sentiment voiced at *PERE*'s Global Investor Forum at the end of April.

Both sides of the equation

The communication issue varies from fund to fund, but Krivinskas notes that his clients in larger closed-ended funds have felt its effects more than those in smaller structures like club deals. Among RVK's clients are such pensions as the Employees Retirement System of Texas, the Orange County Employees Retirement System and the Los Angeles City Employees Retirement System, according to pension documents.

Some LPs are feeling the consequences of this communication drop-off, as GPs can take advantage of a disjointed and unaligned LP base. "It moves the power equation from the LPs over to the GP," says Krivinskas. "Particularly with some of the name-brand funds that may try to pass unfriendly terms or amendments in the middle of a fund commitment period, for example."

Christopher Rice-Shepherd, managing director at Cliffwater, has experienced similar issues on behalf of his clients, which include the Ohio Police and Fire Pension Fund and the New Mexico Public Employees Retirement Association, according to pension documents. "I can think of a particular instance where a legal term was so egregious that it was almost unfathomable to us that other LPs would have gone along with the term," he recalls. The Marina del Rey, California-based consulting and advisory firm began reaching out to other LPs in order to change the term.

"You learn a lot about how other LPs conduct their due diligence, and what we found there was that many didn't know about it," says Rice-Shepherd. "They just hadn't read the documents."

Ted Leary, founder and president of Los Angeles-based Crosswater Realty Advisors, moderated a governance panel at the recent Global Investor Forum that focused on the issue.

He urged LPs to take a more active role in their relationships with managers. "Two or three years ago, I thought LPs would become more forceful about governance, but now everyone's in deal fever and not worrying about it," he says. "Maybe we need two or three more crashes to sort things out."

Despite the problems that come from a lack of communication, there are often reasons why LPs are cautious about contacting other investors in a fund. "They are able to stay focused on the particular interests of their constituents and avoid groupthink when that communication isn't there, and that can be valuable," comments Rice-Shepherd. Furthermore, he notes that general partners often disapprove when their investors are getting too talkative and "stirring up trouble."

"In a good fundraising environment, that can cut against you," Rice-Shepherd says. "If a manager thinks that you are going to run to the other LPs all the time, you may not be a desirable LP for their fund."

Becoming middle men

During the *PERE* conference, multiple panelists called attention to the communication issues within investment vehicles, some calling upon consultants to lead the effort to change. One suggested solution was increased discussions between consultants, but the industry has met this suggestion with mixed reviews.

Krivinskas notes that RVK often speaks with various other consulting groups and, while some firms are more communicative than others, he sees the issue as more of a problem between LPs rather than between their consultants. Still, he understands the need for a more active consultant role. "We can help the communication flow between the LPs and the GP by shepherding that process and taking on a more pro-active approach," he says. "That can certainly happen and does happen on our end."

Leary: LPACs are no longer doing the job

Improving communication between consulting firms might not be the answer, agrees Rice-Shepherd, but increased communication between consultants and their clients, as well as other LPs in any given fund, would be helpful. "Because consultants represent so many different opinions and interests, a consultant-to-consultant relationship actually might not be as helpful as you would think," he says. "The benefit there is you're aggregating capital and voting power, but you're also aggregating interests that might be competing." He believes it would be more effective to have greater LP-to-LP and LP-to-consultant discussions rather than consultant-to-consultant collaboration.

This hands-on role for a consultant is important to Chae Hong as well. However, in his role as senior consultant at Chicago-based Hewitt EnnisKnupp, he more often reaches out to the managers than to other LPs. He adds that the communication gap between LPs and consultants is often bridged at annual investor meetings, where they have an opportunity to network and share concerns.

One issue that consultants may be able to address is the standardization of questionnaires, which are often the point of initial communication that LPs have with a potential manager. While some suggest that implementing one general questionnaire across a consultant firm or industrywide would make things more efficient, the particular investment needs of each LP make it difficult to introduce a standard that functions well for the broad range of institutional investors. "Public pensions and corporate pensions and endowments all operate differently, and the requirements in how they communicate also are quite different," notes Rice-Shepherd.

Open forums

Limited partner advisory committees (LPACs), while intended to give LPs a voice in fund decisions, have become less effective ways for LPs to enact change. According to consultants, one of the most beneficial tactics would be to increase the exposure that LPs have to open or informal forums without the presence or influence of a manager.

Krivinskas recommends that consultants push for terms that allow LPACs to communicate with one another without having the GP present. Hong suggests including a provision in the side letter that the minutes of the LPAC be distributed to all LPs so that those investors not on the LPAC can be aware of major decisions.

Meanwhile, Leary and Rice-Shepherd do not see the efficacy in LPACs to increase LP collaboration. "The problem is, when people sign up for these funds over which they have very limited control, they get caught up in a mirage that the LP committee actually will have some influence over the behavior of the GP," comments Leary. "The traditional use of LP committees in funds simply doesn't work because the LPs tend to be unwilling, unable or afraid to exercise any influence on the GP."

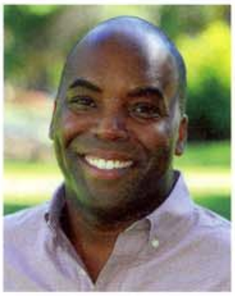
Rice-Shepherd agrees, noting that the presence and influence of the GP often impedes progress for the LPACs, as agendas of meetings typically are set by managers. "Not having the manager present allows the conversation to flow in a direction that's more LP-friendly," he says. "LPACs are good for addressing issues of the day but, when it comes to strategic discussions, I don't think they're effective at all."

In order to facilitate these open forums, Krivinskas proposes the manager provide a list of investors to all the LPs in the fund. While some GPs currently do supply such information, many do not, and the practice is complicated by privacy concerns among LPs. "I think most LPs should not have an issue with this," he comments. "An opportunity for LPs to know who is in the fund could be a vital source of increasing the communication flow."

Moving towards a solution

Despite the issues with many communication channels within funds, advisors note that most managers are not bad actors. Many value the best practices and good governance that allow for more open communication and honest relationships, knowing it will bring investors back when their subsequent funds hit the market.

"There are often managers who are proud of those relationships that they've had with LPs for long periods of time," comments Rice-Shepherd. Indeed, many managers will provide Cliffwater with a list of existing LPs during due diligence to show the relationships they have built over time. "Those are great managers that have nothing to hide," he says.



Rice-Shepard: believes in better LP collaboration

Rice-Shepherd also notes that the recent fundraising trends towards co-investments and separate accounts among larger investors are, in part, a response to the inefficiency of communication between GPs and LPs in traditional commingled funds. "The main reason they prefer those relationships is investment control, but they also can make demands upon how their managers communicate and report with them on certain issues," he adds.

For Leary, the solution to this communication issue is an independent advisory board or committee entirely separate from the GP that can weigh in with a third-party perspective, a strategy employed by such managers as Bentall Kennedy and CBRE Global Investors (see The power of objectivity, below). "It all comes down to the DNA of the GP and the LP," he says. "The GPs don't want to tell you too much and the LPs don't ask too much, so that's why I've concluded that you need to have a different device."

Although these advisors have some influence over the relationship between investor and manager, the communication barrier will not be broken down without more LP action. With less communication working in the managers' favor and the consultants' limited ability to exercise influence over their clients, the power to enact change ultimately rests in the hands of the LPs.

"As things become better in the real estate industry, it's really important for LPs to continue to focus on these corporate governance protections and this communication because there will be a time down the road when things aren't so rosy and they will have wished that they had negotiated and focused on these protections when they could have," cautions Krivinskas. □

The power of objectivity

Firms such as CBRE Global and Bentall Kennedy use independent advisory members in order to introduce a third-party perspective into investment decisions

While some in the private real estate industry want to mend the relationship between managers and investors through increased and improved communication, others think the best solution is introducing a completely independent third party to weigh in on investment decisions.

"It has been positive in the manager's way of looking at investments, and potential clients have been impressed by it," comments Ted Leary of Crosswater Realty Advisors. "If you look in the corporate world, having independent directors is a best practice. So, why doesn't real estate try out some of these best practices?"

Connell: offering an independent view

Toronto-based investment manager Bentall Kennedy has had an independent board of directors for more than 20 years, while Los Angeles-based CBRE Global Investors has had a single independent member on its Americas investment committee since 2010. Currently, that position at CBRE Global is held by Alice Connell, an industry veteran with more than 30 years of experience as a long-time TIAA-CREF executive and current managing principal at consulting firm Bay Hollow Associates.

"It's really helpful for the LPs to have someone who's independent on the board," says Connell. In the role she has held since August, Connell provides an objective third-party perspective as she assists in evaluating and approving major investment decisions for investment vehicles, including the Strategic Partners US fund series, the US Managed Accounts Group and other US equity investment vehicles.

"No matter how good an organization is, it is just normal to have similarity and homogeneity of thought and perspective. It's unavoidable," comments Connell. "So when you insert someone who is unencumbered by that internal perspective, you start opening up a richer discussion, a richer debate and hopefully all of that leads to a better investment outcome."

The industry has been skeptical in its response to independent board members, according to Leary. He says that the task of calling for such roles may lie in the hands of investors. "Most GPs will argue that it doesn't work because they don't want to be second-guessed by sophisticated parties," he says. "They want toothless tigers sitting on the limited partner advisory committee. If it isn't pushed by the LP community, it won't happen."

Although the practice is rare among private equity real estate managers, Connell believes the future will bring an increase in these roles, noting that her business partner recently was appointed to the new board of a major real estate investment manager, the name of which she declined to disclose.

"Everyone is asking, 'What can we do better? What can we do differently?', so I think we'll see more of it," says Connell. "That would not at all surprise me."