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REAL ESTATE / INFRASTRUCTURE / AGRICULTURE / FORESTRY GLOBAL MARKET INTELLIGENCE FOR INSTITUTIONAL INVESTORS

TRADE BALANCE

UNCERTAINTY ABOUT THE FUTURE OF GLOBAL FREE TRADE HANGS OVER REAL ESTATE MARKETS

Is bigger always better?

Ted Leary

When looking for signs that the real estate market might be about to turn, it is always worth watching for M&A activity

I got called by a client several days ago who views me (probably correctly) as Dr Doom because of my asset workout history. He wanted to know what I thought of the markets and when they might turn for the worse.

As I am not an active player in deals, I tried to avoid the question by pleading ignorance (it won't be the first or last time). What I did tell him was that we are in a highly cyclical business and that nobody is going to take the cycles out of it. Stuff's going to happen – sooner or later.

I've written before about the cosmic change in our industry where a bunch of mega-firms now dominate capital raising and thus investing, and are part of what I call the 'private equitization' of real estate investment management.

I was looking at IPE Real Assets' top 100 real estate investment management firms and noticed that the number 10 firm had AUM of more than $60bn, or $80bn. That's 'real money'.

As I operate under the assumption that these firms grew large because they were careful, intelligent investors, maybe their clout in the marketplace means that when a slump hits they can act as a buffer and help prevent it from sliding into a disaster. I must note, however, that many of the Wall Street and Wall Street-related firms that did so well in the 1990s and early 2000s, had pretty miserable track records starting in the late-2000s. Maybe they were not so smart after all.

One note of caution I see is that these firms have been so successful in raising capital that to actually invest these funds they have to make pretty enormous bets or go international. If the markets turn sharply against them, these factors might eliminate some of the perceived mitigants.

Despite these positive indicators, I don't doubt for a minute that the hot markets we are now experiencing are going to shift downward. Where and when I do not know, but it will happen eventually. And we are in the seventh, eighth or ninth year of a strong recovery, which is a long time for our industry to go without some sort of correction. The question is, how severe will the correction be and how long?

Over the holidays I read a couple of articles on 'big data'. Understanding what big data is and how it might impact the real estate industry is way above my pay grade. But I do think I know enough to understand that big data implies big costs. If I am right about that, the big firms will be the ones that can most afford to use big data and will thus get another competitive advantage. Big data is impacting virtually every industry in the world and it would be naïve to think real estate will be exempted.

As the old adage goes, if it seems too good to be true, it probably is. Or as the late economist Hyman Minsky argued, long bull markets inevitably end in large collapses. That's called 'The Minsky Moment'.

I always look for 'tells' to get an unscientific hint of the markets turning. One tell I look for is the increase in M&A activity in the real estate investment management business. If I see small or mid-sized real estate investment managers being sold by their entrepreneurial founders – particularly to large institutions – it's usually because those founders sense that the markets are reaching their peak and the value (the multiple) of their firms are also reaching a peak and it's time to take their personal money off the table. I sense that is going on today.

Or maybe the recent poor showing of the IPO of real estate services group Newmark is a small, but unnoticed, canary in the coal mine? Or maybe recent reports that capital raising for private equity real estate funds has hit the wall.

We at Crosswater don't view ourselves as pension fund consultants – at least in the usual definition. We are really a bunch of crusty old workout and restructuring guys and gals who got together during the global financial crisis to help clients who had never really experienced a horrific drop in real estate values and very poor manager performance. Although I don't view us as 'consultants', Crosswater is, nonetheless, lumped in with them by most people, and it has caused me to observe the changes that may be taking place in the business.

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Real estate consulting really began in the late-1980s as institutional investors began to invest in the asset class. The traditional equity and fixed-income consultants looked down their noses at the real estate business. I remember one traditional consultant telling me real estate managers "were like used car salesmen, but with much nicer suits".

They didn't foresee the value in and/or growth of real estate as an asset class, so they didn't staff up for it. Entrepreneurial firms such as The Townsend Group brilliantly charged into the breach. However, since then – and because of several downturns – investor staffs have learned a great deal about the benefits and vagaries of real estate investing.

A lot of institutional investors – primarily public funds – continue to see a need for consultants, but my hunch is that the 'job description' addressing that need is shrinking. If I am correct, that means less work and less revenue for the consultants. Despite their already modest fees, consultants are now subject to the same fee pressures as the managers. Given these changing economics, will they be able to attract the talent needed to provide truly valuable advice to their clients?

The more strategic real estate consultants have tried to expand into the investment management business, yet retain their consulting business. How clients allow that is puzzling to me given the obvious serious conflicts. I don't blame consultants for finding ways to grow their business – all power to them. But I am amazed that clients allow this to continue.

Another factor I think may be changing is that, at the same time as investor staff gets more sophisticated about real estate, the original entrepreneurial consulting firms are, for a variety of reasons, being drawn into the much larger equity and fixed-income consulting firms. This inevitably will mean that the entrepreneurial spirit of the early consultants will be diminished.

It's just the way it happens, no matter what the asset class or business. The result may translate into less desire to use consultants as they won't see a clear 'value add'. These changes will certainly go on well past my career, but it will be interesting to see if I am correct.