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REALTY ADVISORS

10.22.09 - THE FUTURE OF THE REAL ESTATE INVESTMENT MANAGEMENT BUSINESS

Its been about a year since I was pulled out of retirement to assist several large institutional investors with their real estate challenges. To say that it's been an interesting year is an understatement. I have been absolutely amazed how deep the problems are in the real estate markets and how much economic stress there is in the real estate manager community. So it should come as no surprise to all involved in institutional real estate investment, no matter what their role, that substantial changes are going to be made in how the business is conducted and compensated.

There is little doubt that most, if not all, institutional investors are very unhappy with their real estate returns and frustrated, if not downright angry, with many of their managers. They have discovered, as one client said to me: "These guys aren't the Masters of the Real Estate Universe they claimed to be." They have seen tremendous fees paid to managers over the "hot years", but are currently reporting enormous losses in their real estate portfolios. As a result these investors are now – when they can get a few minutes away from fighting fires – starting to re-look at the whole framework of the business which developed over the past 25 or so years including fees, incentive structures, "alignment", governance, co-investment, vehicles, strategies, fiduciary conduct and more.

As these issues get sorted out, the economics of the investment management business will surely change – and likely for the worse. My guess is that there will be considerable fallout of firms—some people predict up to 30%. The much talked about "consolidation" in the business will more likely be the "elimination of firms and the consolidation of assets." This shouldn't surprise us. As one person (whose name I forgot) put it: "Capitalism without penalties for failure is like Christianity without Hell. It doesn't work!"

One of the first questions I ask clients who are thinking about terminating a manager is: What precisely — in a world where virtually every manager has lost lots of money — is it that has triggered that decision? In virtually every case the answer is: "We've lost confidence in their ability to serve us". Digging deeper I've found that the lack of confidence can be tied to many factors including: very poor returns, poor strategies, poor fiduciary conduct, poor attitude, staff losses and organizational disarray. It's usually some combination of many, if not all, of these. And as we all know, "confidence" is something that once it is lost is very difficult to recover.

One particular complaint that comes up over and over again is managers who pumped the money out at the height of the market. Yes, admittedly that involves 20-20 hindsight, but not all managers did that. Some firms did exercise much greater investment discipline than others. When an investor has that kind of comparison available, some firms just naturally look better than others and some look a lot worse. Fair or not, the conclusion investors often arrive at is that the more aggressive managers were driven by a short term fee mentality, rather than the long term interests of their clients.

One of my particular hot buttons is, when reviewing a manager's investment recommendations, the all-too-often lack of true risk analysis. You see the "Base Case" at a 14% return and the "Downside Case" at a 10% return. Well, life just isn't that fair and balanced. Stuff happens. This is particularly true when we cruised through a market where deals were "priced to perfection" and there was no margin for error. While I don't have a simple solution to the risk management issue, I do sense that, going forward, investors are going to want to see a lot more attention paid to that issue -- possibly even requiring managers to have some sort of strong risk management function/staff in their firms. By that I mean investment risk, not insurance risk.

The problems generated by the lack of true risk analysis and management were exacerbated by the fact that leverage was so cheap and readily obtainable. Well, we've seen the consequences of that both in the single family housing sector and the - supposedly - more sophisticated commercial markets. Disaster! I think that most investors are going to want to de-leverage their existing portfolios and to use far less leverage going forward. This will obviously have an impact on returns which in turn will have an impact on a manager's fees.

So what other changes can we expect to see? Below are some totally random thoughts.

Fees: As a general matter, I suspect that "power" will shift to the large institutional investors and away from the managers. For example, fees are sure to come down as the investors feel that the managers didn't deliver the goods. You are already seeing this phenomenon in the private equity world with the creation of the Institutional Limited Partners Association – where the big investors are going to pursue a concerted effort to lower fees, amongst other goals. As the headline in the FT said in announcing this new group: "Wave of dissent builds against high fees". This aggressive approach will likely be eventually adopted by the real estate investor community.

Stand-by or commitment fees will likely be cut or reduced.

Asset management fees will also be reduced or reconfigured

Performance fees hurdle will be higher. Although as a natural contrarian, I think this particular issue needs a lot more thought. I have observed in many cases that the high hurdles drove the managers to take bigger and bigger risks. So an argument might be made – after an era of dramatic capital losses – that lowering the hurdles might be a safer investment strategy. Plus thinking everybody can beat certain hurdles is naïve. It's the real estate equivalent of Lake Wobegon, where everybody is above average.

Mid-term or uncrossed incentive fees will be eliminated. If a manager does want a mid-term fee then clawbacks - enforceable and bankable - will be needed. To avoid clawbacks, managers will have to accept waiting until their fund is completed and the client's capital has been totally returned – hopefully with a healthy profit.

Governance: Most institutional investors we talk to will be unwilling to enter into partnership agreements where they don't have a much stronger voice in the investment vehicle and process. In fact, we are already seeing the use of so-called "shadow managers" who represent the investor in tightly overseeing their managers, especially the ones with the most troubled assets or organization. As the use of these "shadow managers" grows, they could morph into a longer term role. Investors may ask for some representation on a manager's investment committee through the use of independent committee members, akin to independent directors in a public company.

Obviously to remain a Limited Partner there are limits to what the investors can do, but I believe it's reasonable to expect the LPs to be more assertive. For example, instead of managers being protected by the need for a "super-majority" of investors to remove a manager, the hurdle will likely drop to 51%. Plus termination rights may be expanded well beyond "cause". "Discretion in a box" will likely involve tighter definitions giving managers far less flexibility than in the past 5-10 years.

Co-Investment: In my personal view, the jury is out on the value of manager co-investment. I understand the theory, but have yet to see any convincing evidence such co-investments actually

make a manager a better investor. In fact, I've observed managers with no or minimal co-investment doing quite well and others with significant co-investment losing most of their and their investor's money. But at a minimum, the investors want to make sure the manager "hurts" as well as the investor, if a deal goes bad. This requirement, of course, could penalize a lot of people, especially younger, smaller firms as they don't have the requisite level of capital. Then you would only have "bigger" firms at a time when bigger has not necessarily meant better.

Manager Organizations: On the subject of " Is bigger better?", I am beginning to think NOT. There has been a clear tendency to push money out to the larger, name-brand firms with multiple platforms. It was easier for the investors' staffs and the consultants as you only had to underwrite an organization once. Plus there was the old "nobody got fired for buying IBM" logic. But we are now seeing that many of the biggest losses - dollar amount and percentage wise - are coming from the biggest firms. One reason, as I see it, is that nobody, no firm, is good at everything. Life is too complicated for that and real estate in the end is still a local business where local knowledge and skills are crucial to success. These local skills are hard to expand/replicate on a global basis.

A friend of mine in London has commented to me on another factor: He believes that once a big firm gets a humongous level of assets under management (AUM), the growth of AUM becomes the true economic driver of their business - not necessarily performance. This causes the BIG FIRMS to raise more money and to push that money out as fast as they can as it's the fees based on AUM that create the high incomes for the managers. Incentive fees are just gravy. I ran this by a friend in the investment business - not real estate, but with $50 billion in AUM. His response was: "Aha! You just stumbled upon the secret of the business!" Food for thought, especially for investors and consultants.

Also consistent with the investors' increased focus on fiduciary conduct, there will be a renewed attention to the perceived conflicts of interest in vertically integrated organizations. Investors will want to insure that their managers are not double-dipping (or worse) on fees. The same concern goes for double and even triple promotes.

So what does a manager do?

First, it is unlikely that a single investor will want to enforce of all of these changes outlined above. If they do, you might want to look for another profession. But even if they require just a few of them it

will certainly impact the flexibility and profitability of an investment manager. Thus managers need to start thinking NOW about how they reposition their firm to meet these new requirements and standards. My advice is:

- Develop a true risk management role in your company that an investor can believe in.

- Figure out how to motivate your team when profits and thus bonuses will probably be diminished and the "pot of gold" of incentive fees may be years away.

- Restructure your organization to keep overhead low - as we all well know now, in an era of declining revenues, "overhead kills". But don't cut into your core competency.

- Most of all be very, very open with your investors about your assets, your organization and any other issues you may be facing. If there ever was a time when you followed the "No Surprises" and "Open Kimono" rules, it is now.

Those firms that figure out how to retain their investor's confidence - even in this difficult market - and position themselves for the "Next Era", will be the winners when the cycle finally turns for the better. In the end, long term success in the investment management business depends on the character and competence of a manager's organization and its people.

Ted Leary
President, Crosswater Realty Advisors