

## **“Ramblings” on the Real Estate Investment Management Industry: Real Estate Plus, Sharpshooters and UMMS**

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It’s been quite a while since I last wrote one of my “Ramblings”. As the “workout” stage of the past tumultuous cycle is ending and the real estate markets have stabilized (and are overheating in my humble opinion) I am cruising back into semi- (or more) retirement. This is probably a good time to reflect on the institutional real estate investment business. My hunch is that the business is going to go through significant shifts over the next few years.

I’ve been in the business since the mid-1980s when my old firm was chosen to do the workout on a troubled British pension fund property unit trust burdened with a bunch of B-quality U.S. assets in B-locations. At that time the institutional real estate investment was just beginning in the U.S. – in many ways created by Peter Aldrich at The Boston Company Real Estate Counsel. The early adopters/entrants, the “First Wave”, were life company real estate departments, syndicators, brokerage houses and some entrepreneurs. All in all, there were probably only 20-30 firms I was competing with at that time -- which was nice!

The real estate recession in the late 1980s shook up that comfortable situation and many early institutional investors almost dropped out of the asset class feeling that the managers had “over-promised and under-delivered”. Then came the Second Wave as Wall St firms

discovered real estate – in the form of RTC and other pools of non-performing or under-performing assets. I vividly remember chatting with a friend on Wall St about a large pool of C-B apartments he had just purchased in an RTC bid and asking “where did you get the manpower to underwrite all those assets”. He replied he didn’t look at any assets. To him it was a “price per pound play”. He said “last year I was doing pork bellies and this year apartment units. It’s all essentially the same.” Wow! Was that an eye-opener into the new world of real estate investing! Add to that the ability of Wall St firms to co-invest (albeit with “house money”) in their offerings enabled them to attract large amount capital from disappointed institutional investors. This enabled the Wall St firms to basically “buy the business” and they quickly became major players. (As those who know me remember I don’t believe there is any correlation between manager co-investment and performance, but that is a view not widely shared – especially by the investor community and their gate-keeping consultants who have come to believe there is some magic in co-investment.) That strategy of buying troubled assets was brilliant and they produced fantastic returns, but when the markets recovered and stabilized, their increasingly aggressive use of higher and higher leverage combined with their ability to raise massive amounts of capital did not end well as those same Wall St firms – b/t/w with all their (house-money) co-investments – produced probably the most horrific losses in the “late Oughts” (2005-10).

In doing workouts and manager restructurings for several major public pension investors over the last 5-6 years I observed that the firms that did well over that same periods of time ( the late Oughts) had several common attributes: limited leverage – which they decreased as the markets got more frothy, excellent risk-cognizant sell disciplines and

were generally highly focused on 1 or 2 property types. I call them the Sharpshooters. There are obviously exceptions to that rule, but not many.

We are now entering into a “Third Wave” in our business. I’m not sure what to call it, but will go with the “Private Equity Phase” with Blackstone being the ultimate example. You now have firms -- like Blackstone – which have a very Private Equity mindset raising enormous amounts of real estate capital. They are certainly not the “Sharpshooters” I mentioned who did so well in the Oughts. In fact, nobody is as “global and highly diverse” as Blackstone -- and so far, it seems to be doing quite well. My perception is that firms like Blackstone look at real estate through a private equity lens. When I was an active investor we would buy an asset, hopefully manage it well and then eventually sell it at a nice profit. It was more of an asset-by-asset strategy, while Blackstone and other mega-firms appear to collect assets with some sort of PE exit strategy in mind --- possibly from Day 1 with the first acquisition. I call it a Real Estate Plus strategy with the “Plus” adding additional value through some version of a PE play. The investor community seems to be buying into this new approach as the RE Plus firms are raising (and I say this in awe) of somewhere between 35-45 % of the available investable money.

(NOTE: I sent a draft of these Ramblings to my friend Roy Schneiderman of Bard Consulting who had the following comment I think is worth sharing:

*I followed your point along a bit in my head and got to the following, somewhat interesting hypothesis/question.*

*The broad asset allocation models that justify institutions investing in real estate are based on the “Leary-like” view that real estate is a “hard asset” with traditional real estate characteristics.*

*I wonder if “real estate” investments in the Blackstone/pork bellies style actually behave the way asset allocation models expect real estate to behave. Particularly because PE exits are often public market driven, I wonder if Blackstone investments correlate relatively more with public market performance and relatively less with, say. ODCE or NPI?*

*The Blackstone PE model is the logical extension of the line “last year I was doing bellies and this year apartment units”. )*

Roy raises an intriguing question for the Quants out there!

After the Real Estate Plus firms you have the “Sharpshooters” who have very highly focused strategies – similar to what I observed above. If they produced a successful track record thru the tough times they will be able to compete with the PE Plus players and raise – my guess - 10-20 % of the available capital out there.

Then you have what I call (for lack of a better description) the “Undifferentiated or Muddy Middle” firms (the “UMMS”) competing for the remaining 30-40 % of the investable dollars. These are not necessarily bad or poorly performing firms, but there are hundreds of them out there and unless they have some clear way of dynamically differentiating themselves from their competitors it is going to be a tough slog.

( See my 2012 blog at [http://crosswateradvisors.com/wp-content/uploads/\\_ramblings\\_pdf/152-5acf5f1b.pdf](http://crosswateradvisors.com/wp-content/uploads/_ramblings_pdf/152-5acf5f1b.pdf) ) Obviously the UMMS who have poor track records and/or behaved badly during the late Oughts downturn (which far too many firms did) will slowly disappear as their AUM will over time decrease and they will not be able to replenish it. This is especially true for firms who had lousy performance but lacked the grace and wisdom to voluntarily reduce their fees – a decision which investors long remember. I must admit to my amazement that some poorly performing and/or behaving firms have been able to continue to raise new funds. I don't get it!

This phenomenon will be exacerbated by the movement, led by CalPERS, to substantially reduce the number of its real estate managers. I recently moderated a small conference of institutional investors and asked them if they were going to follow CalPERS' lead in reducing their managers. Most of the respondents said "Yes", although none were planning on as dramatic a reduction as CalPERS.

Another factor that may be driving the growth in the Real Estate Plus firms is institutional investors' desire to expand into global markets. Global investing is, for obvious reason, more expensive and risky—especially in Emerging Markets which can have dangerously relaxed versions of honesty and fiduciary behavior. The Real Estate Plus firms, with their global office networks which are likely to be more attuned to currency risks and sophisticated compliance departments, may thus appear to investors to be a safer bet for international investing than smaller entrepreneurial firms.

The emergence of the huge Sovereign Wealth Funds and the expansion of the “Canadian Model” of direct investing are also phenomena which should have a serious impact on the business. I think it’s too early to tell just what those impacts will be.

Finally there is always the modern real estate version of the old “you don’t get fired for buying IBM” rule. Now its “you don’t get fired for investing in a Blackstone fund” So far it’s been a pretty good choice for investors’ staff to make.

This does not bode well for the UMMS . It kind of reminds me of the battle for grocery store shelf space. The big players -- the Proctor & Gambles of that world - get ample space and the boutique health food players get some, but the middle players get squeezed down. I have friends in our business call me all the time about what they can do to counter this challenge and my only advice is “focus on differentiation” and try not to be all things to all people as that is, in my opinion, the very definition of the “UMMS”. Firms need a compelling story to separate themselves from the huge pack of UMMS.

In addition to this “Tri-Furcation” of managers, investors have become increasingly focused on the total fee loads they have been paying, the governance of their investments and the need for incentive compensation to be “crossed”. Each investor puts different weight on these issues, but the great majority of them are going to be more demanding of their managers in the future. Add to that the fact that the SEC is now getting much more aggressive in its scheduling and the demands of their audits and thus raising compliance issues and costs very high. The world is certainly changing!

So what does this all mean for institutional real estate management firms? Managers who hope to survive and prosper will need to be much more strategic, efficient and productive – something that wasn't necessarily needed in the easy money boom years of the early-mid Oughts.

We are probably going to see a reduction of the number of firms – maybe a substantial reduction. For those who know the industry's history, many of the top 10 firms from the First Wave (1985 – 1995) no longer exist. There is no reason why there shouldn't be a similar shakeout in the industry after the problems in the 2007-2012 period.

Isn't that capitalism at its most efficient?