The Emerging Role of the Independent Fiduciary for Non-Traditional Real Estate Investments

by Tom Hester & John McMahan, CRE

A recently published survey of pension plan sponsors[1] attempted to make big news of the fact that a number of the plans intended to reduce their respective allocations to real estate investments in the future. What is surprising about the survey to the authors, was the fact that only some 13 percent of those responding indicated that they would reduce their allocations. The authors do not consider the results to be particularly significant, especially when a number of pension plans, including CalPERS, CalSTRS, and New York State Teachers, have recently announced substantial allocation increases to the asset class.

These increases can be rationalized, in part, by pension plans' redefinition of the role of real estate in a multi-asset portfolio. Real estate investments may now include technology-related investments and higher return/higher risk vehicles such as opportunity funds, joint-ventures, development programs, foreign investment, and the like. Pension plan sponsors have recently discovered the value of an independent fiduciary in evaluating these non-traditional real estate investment opportunities.

In most cases, investments of this type are sponsored by firms that are not registered investment advisors. Seeking to provide some assurance that these investments meet minimum fiduciary standards, pension funds are turning to independent fiduciaries to perform due diligence,

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identify risks, suggest mitigation as necessary, and render overall advice on the desirability of the investment. The independent fiduciary performs the front-end analytical functions that would be undertaken by an investment advisor in a more traditional core real estate investment, and also gives the pension plan sponsor an investment recommendation based on its analysis. The recommendation is possible, and depended upon, because by law the independent fiduciary must be a registered advisor.

EVOLUTION OF THE FIDUCIARY STANDARD OF CARE

The role of the pension fund investment fiduciary was first described in the Employee Retirement Income Security Act (ERISA) of 1974. Under ERISA, a person or firm is deemed to be an investment fiduciary if they make recommendations as to the advisability of investing in, purchasing, or selling securities or other property, pursuant to a mutual agreement between the parties.

This fiduciary standard of care was subsequently refined to establish who would be considered an investment advisor and the level of prudence under which they were expected to act. Initially, investment advisors were required to be commercial banks, insurance companies, or Registered Investment Advisors under the Security and Exchange Commission. This was subsequently modified to allow smaller firms to register with state regulatory authorities. For pension funds desiring additional protection, the Qualified Plan Asset Manager (QPAM) designation was established by the Department of Labor (DOL), requiring certain levels of financial size and assets under management.

TRADITIONAL ROLE OF THE INDEPENDENT FIDUCIARY

ERISA contemplated that the occasion might arise when the DOL, acting through the courts, would be faced with the necessity of replacing the fiduciaries responsible for a pension plan's assets. Since this might take some time, the role of the independent fiduciary was established by the DOL to be responsible for the assets of the plan and its operation until such time as new fiduciaries could be secured.

In recent years, several plans have utilized independent fiduciaries to evaluate situations in which a significant modification was being proposed in the structure of existing investment vehicles. Examples include the sale of plan assets, the rollup of portfolios to create a public company, asset transactions between related plans, and other situations where an independent opinion was required. Investment advisors also have proposed the use of independent fiduciaries in situations where a conflict of interest existed or was perceived to be a possibility.

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USE OF THE INDEPENDENT FIDUCIARY TO EVALUATE NEW INVESTMENTS

Earlier this year, The McMahan Group was awarded a contract to provide independent fiduciary investment services to a major public pension plan. The purpose was to assist its Board in evaluating certain new investment opportunities that had been previously determined by staff as meeting the plan's overall strategy and investment criteria.

In this capacity, we performed due diligence on each proposed investment in terms of its strategy, structure, pricing, congruency of investor/sponsor interests, and, if specified, the quality of assets in the portfolio. In addition, we evaluated the track record and investment performance of the sponsor in prior investment activity and the relevancy of this activity to the proposed investment program. The ability of the sponsor to successfully implement the proposed investment plan in the future was also evaluated in terms of overall firm strategy, management capabilities, staffing levels, reporting systems, and financial resources.

Since many of these proposed investment strategies utilized joint-venture arrangements or "platforms" with local real estate firms, it was often necessary to evaluate these firms as well in terms of the organizational criteria outlined above. It also was critical to establish the reputation and local market knowledge of the joint-venture partner and its ability to find and manage investment opportunities.

At the conclusion of the due diligence analysis, a recommendation based on the overall merits of each investment opportunity was provided. A conclusion to invest was always subject to a number of risk mitigation recommendations involving firm policy issues, organizational changes, and pricing and investment term renegotiations. A conclusion not to invest was based on the totality of the remaining risk in the investment opportunity that could not be mitigated away.

The major steps in the due diligence process are outlined below:

STEP 1 - TRANSACTION ANALYSIS

A "top-down" analysis to determine if the proposed investment fits into the pension plan's investment strategy:

- Consistencies of the proposed investment with the pension plan's return objectives.
- Proposed sharing of investment risks and rewards and whether the sharing is consistent with the individual interests of the parties.
- Strength of the market for similar investment vehicles.
- Reasonableness of the acquisition strategy (including property type and location).
- Soundness of the proposed exit strategy.
- Risk components inherent in the transaction and the probability of the realization of projected returns.

STEP 2 - TRANSACTION STRUCTURE

A detailed analysis of the investment structure, terms, and pricing in the form of a "bottom-up" review and benchmarking to alternative investments and market pricing:

- The use and impact of leverage, including a comparison against favorable terms currently available in the capital markets.
- Existing or potential conflicts of interest, including those that may be related to portfolio joint-ventures, platform investments, and services including brokerage, property management, etc.
- The financial terms and pricing of the transaction.
- The investment return structure, with a particular focus on the incentive and management fees paid to the investment sponsor and under what conditions they are earned.
- The funding commitments of the sponsor and possible risk factors, if any.

STEP 3 - FINANCIAL PROJECTIONS

A testing and verification of the sponsor's financial calculations and projections:

- Recalculation of proposed investment returns utilizing proprietary financial models in order to provide an independent verification of the sponsor's projections.
- If required, portfolio analyses including risk and return measurements as well as indexing to the plan's benchmark (NCREIF, nominal, real, or risk-adjusted return).
- Testing of sponsor's projection assumptions against a market-supported range of reasonable assumptions. If current appraisals or other valuations are relied upon, they should be tested for scope and reasonableness.
- Secondary research focused on specified portfolios including economic and demographic trends; property market conditions; rental rates and concessions; occupancy levels and absorption; expense data; competitive supply; development activity and approved projects; ordinances and legislation; and other relevant statistics.
- Primary research (utilized for both specified property portfolios and blind pools) including interviews with participants in the transaction (*e.g.* sponsor management, lenders, platform partners, etc.) as well as third-party sources (*e.g.* appraisers, investment brokers, leasing brokers, property managers, financial institutions, etc.).
- Sample tenant lease evaluation comparing contractual terms to market terms, duration risk, flexibility, and tenant credit.
- For specified portfolios, site inspections for selected properties focusing on building quality, amenities, general condition, location advantages and disadvantages, infrastructure, egress, visibility, and competitive position. Comparable properties should be researched in order to obtain rental rates, occupancy, and other performance data.

STEP 4 - INVESTMENT SPONSOR EVALUATION

An evaluation of the investment sponsor's organization, focusing on management capability and organizational capacity (if applicable, these procedures can be performed in full or limited-scope on platform partners as well):

- Determination of whether the principals have developed a well-thought out firm strategy, and possess the required competencies, procedures, and systems to execute it successfully.

- Sponsor investment track record, recalculating and verifying realized returns and return projections on unrealized investments.
- Evaluation of the core competencies of the firm to assess whether the requisite experience, skills, and leadership qualities exist within the firm to implement the strategic objectives.
- Review of operating policies, procedures, financial reporting, and technology systems for completeness and adherence to current industry standards and trends.
- Review of firm organization, focusing on structure, reputation and relevant company risk factors, key management personnel and dedicated time, as well as the operations of various firm committees (*e.g.*, investment, strategy, policy, property management, etc.). Evaluate with regard to known industry best practices and successful policies. Review employee recruitment and attrition, management succession, compensation, financial operations, capital-raising, takeover or acquisition likelihood, expansion, etc.
- Obtain and check professional and financial references, evaluate potential conflicts, and research possible legal problems identified for resolution. In particular, any possible investment or fiduciary conflicts that might affect the proposed investment program. Make independent queries into the marketplace in order to assess reputation, business acumen, and integrity. Legal due diligence of current or pending litigation should be referred to plan approved counsel for review.
- Make an overall comparison of the strengths and weaknesses of the sponsor with the proposed investment program.

STEP 5 - RISK ANALYSIS AND MITIGATION

The final step in the due diligence process is to evaluate the risks of proceeding with the proposed investment against the probability of securing projected investment returns. Each risk is identified and ranked in terms of its potential impact on the success of the investment. Sponsor mitigation measures are identified and evaluated in terms of their effectiveness in reducing potential risk. If warranted, additional mitigation measures are recommended to better align risk and return. These measures may include limitations on certain types of investments, revision of the pricing terms, organizational restructuring, dedicated personnel, inclusion of additional investors, etc.

CASE STUDY

A hypothetical case study can serve as a prime example of how the independent fiduciary performs a valuable service.

Use of the independent fiduciary will most likely increase as more plans utilize non-traditional vehicles such as joint-ventures and partnerships in their moderate and higher-risk real estate investment programs. For these plans, securing independent investment advice will be critical to the underwriting process and, ultimately, the investment decision itself.

Workers' Pension Plan (Workers) has been solicited directly by an investment sponsor seeking a large equity investment commitment for the development of commercial urban infill projects. ABC Development (ABC) is a fast growing regional developer that has never before solicited pension capital and has not developed much of an institutional reputation among the major pension plans. However, for some time now, ABC has been structuring successful single-asset joint-ventures and developing institutional quality projects utilizing equity capital from investment banks and the private capital units of several large commercial banks. Other institutional capital-backed developers are now competing directly with ABC for projects and consider the firm to be a major competitor.

ABC is looking to establish a relationship with Workers for these major reasons:

- To reduce the overall cost of its equity capital;
- To structure a separate account relationship with a future commitment large enough to allow it to move more quickly on, and increase the size of, the projects it pursues;
- To improve its market position and grow into an institutional quality firm.

Workers' real estate staff is interested in ABC. The proposed opportunity, as described in ABC's solicitation materials, meets all the plan's strategic and investment criteria for higher-risk real estate investments. The investment board of Workers is also interested but needs assurance that the investment opportunity is suitable for a pension plan and that ABC's strategy, track record, competencies, policies

and organization, with respect to the investment, support the approval of a commitment. The board has asked for the appointment of an independent fiduciary to perform due diligence services and provide a recommendation on the investment opportunity.

During the course of its procedures, the independent fiduciary (IF) discovers several significant operating strengths of ABC including sound, strategic vision, and capability. IF also verifies an outstanding track record on realized investments. However, IF also discloses many relevant findings and conclusions that give rise to serious concerns regarding any possible investment by Workers. Among these are the following:

- ABC has not developed the internal reporting systems required for a pension investor;
- The firm has not structured its development/asset manager incentive compensation model to be tied to the performance of the specific pension plan-financed projects; instead, bonuses are tied directly to the overall performance of ABC as a firm;
- ABC's key personnel work on many projects at once and no "key man" clauses are offered to Workers;
- The proposed preferred return on Workers capital is low compared to others currently offered in the marketplace; and
- ABC's proposed acquisition and asset management fees are higher than those currently offered in the marketplace.

Based on these findings alone, IF cannot recommend that Workers proceeds with its plan to invest in ABC. However, if during the course of the procedures satisfactory mitigation is achieved, a recommendation to proceed is possible. Therefore, as part of its procedures, IF recommends mitigation measures that ABC agrees to:

- Hire an experienced director of internal reporting and accounting. The hired is familiar with industry-accepted reporting standards and previously held a similar position with a large public pension plan;
- Change incentive compensation policy so that a significant portion of development and asset manager bonuses are tied directly to the overall performance of the specific projects, rather than the overall performance of the firm;
- Draft a "key man" clause into the joint-venture agreement stating that no less than 75 percent of key personnel's professional time is dedicated to the venture;
- Increase the preferred return on Workers' capital to a level slightly above market; this compensates Workers for risk based on the fact that ABC is commencing a business model slightly different than its experience; and
- Reduce acquisition and asset management fees to a level currently supported by the marketplace.

Based on the above, IF issues its complete report and recommendation to invest to the investment board of Workers, which then votes on final approval.

A VIEW TO THE FUTURE

Use of the independent fiduciary will most likely increase as more plans utilize non-traditional vehicles such as joint-ventures and partnerships in their moderate and higher-risk real estate investment programs. For these plans, securing independent investment advice will be critical to the underwriting process and, ultimately, the investment decision itself. In this context, the independent fiduciary provides a valuable professional service that allows pension boards to consider a much wider spectrum of real estate investment opportunities, consistent with their fiduciary obligations. REI25

NOTES

1. *Pensions & Investments*, "Sponsors Plan to Reduce Real Estate, Value Stocks," July 10, 2000.

ABOUT THE AUTHORS

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