Partnerships in Global Real Estate

by Lorenz Reibling

At the "Global Cities in an Era of Change," International Real Estate Symposium, September 4-6, 2002 held at Harvard University, how to manage risk over diversified real estate pools was a much discussed topic. The main division was over single or multiple bets on real estate entrepreneurs operating in diverse markets. This discussion is not new, but in today's world of uncertainty surely has new value and deserves a fresh look. The guiding questions for assessing this topic should be:

1. How do you reduce the intrinsic risk of a real estate asset?

2. How does a global investor, such as an insurance company, a pension fund, or the truly wealthy family office most efficiently distribute capital over markets and risks?

3. The common denominator in these discussions is the recognition that real estate by definition is immobile. Most European languages use terms such as *immobilier, Immoblien, immobili* etc. that reflect this attribute better than the English term "real estate." How to deal with the local nature of real estate, particularly in regard to people and financing, is much disputed.

Put in a nutshell, the two camps are divided along the following fault line:

1. Group A trusts the "best" local partner or operator in each individual market and desires to maximize the return by actively searching for those partners or operators.

2. Group B trusts one diversified real estate partner, who in turn has operations in numerous markets under one set of controls and typically uses the same brand name as a business asset in all markets.

Conventional wisdom would suggest that, in theory, Group A should indeed harvest higher returns over a constant risk, assuming that Group and Group B would invest in the same type of real estate, at the same time, using identical leverage, operating costs, etc. Obviously, such conditions rarely if ever occur, but the distinction is useful in thinking clearly about the problem. It is indeed one indicator of the difficulties in executing a coherent investment strategy over a large number of operating entities.

The evident advantage of Group A is the higher degree of diversification. Group A is operating not only over different markets, but also different companies. If it is desirable to spread risk in the portfolio, it seems to be a fruitful approach to real estate investing.

But, offering a not far-fetched analogy, the likelihood of collecting a gallery of Van Goghs, Boticellis, Rembrandts, and Singers by simply visiting distant and exotic places while meeting interesting people is borderline absurd. Artists—and real estate operators—of this exquisite caliber are equally rare. Hence any investor should recognize the limited supply of such talent. Given this shortage of excellent and—today maybe most important—trustworthy partners, the strategy used by Group A is extremely time consuming. It also comes with a great intrinsic risk to this approach, one that is often overlooked: the more people you have to trust with your investments, the more likely you are to pick a bad apple out of the bunch. U.S. institutions are still nursing the wounds suffered by confusing superb, but unfortunately falsified replicas with the real thing. Remarks one major U.S. hedge fund investor about a transaction in Western Europe: "We could have never imagined how a bunch of pin-striped, serious-looking bankers pulled us over the table as if we were naive beginners."

Group B investors may avoid the worst mistakes predictably more often than Group A investors. Making a series of "good picks" in multiple markets is much harder, than building one good relationship with an operator active in the same markets.

The "people factor" is a risk widely underestimated in an industry driven by "deals," as if these individual transactions were virtually devoid of a significant management risk. But it should be apparent that the higher the expected returns, the higher also the "people risk." Managing real estate risks in repositioning, refinancing, or even devel-

oping and redeveloping is, by any measure, comparable with risks inherent in manufacturing procedures such as re-tooling, introduction of new products, or major capital events such as the issuance of debt or an IPO. Nobody in his right mind would leave the management of such risks to unknown characters with a merely parochial understanding of the world.

This by no means minimizes the value of the local operator. In fact, even an entity chosen by Group B might in certain well defined cases enter into joint-ventures with local operators. This would typically be in the first few years of breaking into a new market, or for specialty projects with complex technical, financing or political risks.

Group B investors rely upon the integrity, corporate governance, and standardized reporting systems of their relationship partner to make exact comparisons between various risk/return events across multiple markets.

The most prominent feature of a single entity is the ability to gather, format, and preserve input from numerous markets over various real estate cycles. Experience generates an important "gut feeling," a sense that "we have seen that before" or "they do this differently there." Such judgments can then be verified with independent market data.

The ability to compare notes and transfer know-how in assessing and managing risks requires a central brain or processing entity, distant enough from the micro-management issues of the local theater, yet still close enough and capable enough to interact decisively and authoritatively with local risks and opportunities. This indispensable know-how cannot be imbedded adequately within mammoth investment houses. The psychology of the top real estate minds runs counter to the notion of institutional domesticity. Rather than working with a toothless tiger, sophisticated investors need to interact with market opportunity.

Prudent investors have learned their lessons and adjusted their investment programs accordingly. Rather than investing in the best deals or the best people in a specific market, they invest in a competent real estate organization, a brain, with eyes, ears, and a nose that sees, hears, and smells beyond the local weather report. This relationship partner is defined by documented high integrity under duress, deep real estate know-how condensed into a relatively small number of top executives and the impeccable ability to not only perceive but report changes in risk. These type of organizations are few and far in between. Such a proven relationship partner can be invaluable in sorting out the true opportunities from the mountain of "irresistible" real estate deals presented to any large investor.

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