Thoughts on the Relationship Between Institutional Investors and Real Estate Emerging Managers

BY JOHN J. BACZEWSKI, CRE, CPA

INTRODUCTION

The ongoing industry-wide discussion of emerging manager investment is a topic this author has followed closely and discussed extensively with a number of industry participants. In April 2013, while presenting data from the *Institutional Real Estate FundTracker* database, John Hunt of Institutional Real Estate, Inc., noted: "There are 819 funds in the market today, trying to raise $250 billion. Of those 819 funds, 297 funds (36 percent) are first- or second-time funds." This highlights the challenge faced by both emerging managers and institutional investors. Investors often lack the necessary resources to sort through the volume and see investing in first- or second-time funds as exceeding their risk appetite. It isn't easy to stand out in the crowd. This article suggests several opportunities for behavioral and business model changes that could foster more and better relationships between institutional investors and emerging managers.

BENEFITS OF EMERGING MANAGER INVESTING

Investor Perspective

The institutional investment community generally recognizes several benefits of investing with emerging managers. These benefits include economic considerations such as obtaining exclusive rights to a unique pipeline of investments; an opportunity to identify best-in-class emerging managers, typically working directly with the firm's principals, who maintain "hands-on" investing and asset management responsibility; forming long-term relationships with the next generation of real estate investment managers; and an opportunity for those who provide programmatic equity capital to generate above-market terms and economics because of the scarcity of capital allocated to individual emerging managers.

About the Author

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Baczewski's institutional real estate experience includes independent fiduciary services, investment strategy development, portfolio and asset management, due diligence and transaction management, operational reviews, accounting, performance measurement, client service and capital formation. He chairs the REIS Board, which promulgates information standards for the institutional real estate investment industry, and formerly served on the REIS Council.

Baczewski is a Counselor of Real Estate, a fellow of the Homer Hoyt Institute, a former editorial board member of The Institutional Real Estate Letter-North America *and currently serves as a director of Benchmark Research Technologies, an independent research and strategic consulting firm serving the real estate industry. He participates in the National Council of Real Estate Investment Fiduciaries, Pension Real Estate Association, American Institute of Certified Public Accountants, CFA Institute, the Boston Security Analysts Society, and the Massachusetts Society of CPAs.*

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Thoughts on the Relationship Between Institutional Investors and Real Estate Emerging Managers

In addition to economic considerations, institutional investors can achieve several portfolio construction benefits through establishing an emerging manager investment program. These include capital diversification across a broader pool of operators from early stage to more established, including minority and women-owned business enterprises; and an opportunity to satisfy specific unmet portfolio construction objectives such as accessing a particular property type or building a specific geographic concentration.

Whichever of these benefits drives an institutional investor to develop an emerging manager investment program, an institutional investor can utilize any vehicle structure, target any property type, geography or risk position and use any investment advisory relationship in designing such a program. Emerging manager investments can be accessed through multi-investor commingled funds, single-asset joint venture/co-investments and programmatic joint venture relationships. Important for institutional investors, risk exposure can be targeted as emerging managers participate in a wide spectrum of property operating strategies, enabling institutional capital providers to select whatever investment strategy complements the balance of the portfolio.

So with apparent benefits easy to identify, why has so little institutional capital been allocated to emerging manager programs? One answer is simply that it is more difficult to identify, underwrite and manage emerging manager relationships and investments than those with established managers familiar with institutional investor expectations and requirements. This is especially true when considered against the reality that emerging managers tend to be smaller teams, focused on niche strategies. Investors often must become comfortable with a smaller allocation that can be made to emerging managers without overwhelming their internal infrastructure or execution capacity. It's often difficult for such investments to individually impact the portfolio.

Manager Perspective

An emerging manager often achieves greater platform stability by partnering with institutional investors. This predictable access to capital in larger amounts facilitates the investment process by focusing the manager on specified investment objectives while providing marketplace credibility in the pursuit of transactions. Additionally, institutional capital often precipitates both portfolio and company growth.

Why have emerging managers struggled to raise institutional capital? Emerging managers often are frustrated by the process of accessing institutional capital as they frequently don't intuitively understand the institutional capital formation process and need training in meeting the related information requirements and expectations. Additionally, emerging managers often desire greater investment discretion than institutional investors are comfortable providing at the inception of a relationship with a newer market participant.

FROM WHERE DO EMERGING MANAGERS 'EMERGE?'

Becoming an institutional real estate investment emerging manager suggests that your team has been formed in one of the following three ways:

Figure 1

Sources of Emerging Managers

Source of Emerging Manager	Examples
Existing Entity with Other Businesses Elects to Offer Real Estate Product	Private Equity Firms; Financial Institutions
Existing Real Estate Entity Migrates Capital Platforms	Developers and Operators
Early Stage	Team Lift-Out/Re-Grouping; Start-ups

Source: Real Estate Fiduciary Services

In the order shown in the chart: 1) during the past several real estate cycles, private equity, hedge funds and other financial firms have developed real estate investment products. Such firms tend to see real estate investing as augmenting existing investment activities and providing their clients with a broader array of investment vehicles, supporting overall business growth; 2) many real estate-focused entities have successful track records managing capital from other sources (internal capital, friends and family capital, etc.); and 3) the early stage organization may consist of a team leaving a larger organization or a group that sees a business opportunity and combines resources.

These managers have different capabilities:

- Financial firm personnel may have existing institutional relationships resulting from the firm's other businesses; they may not necessarily constitute an emerging manager as much as an extension of the business lines of an existing, successful investment organization. As part of an established entity, they are very likely to obtain capital allocations from institutional investors without the support provided by an emerging manager program;

- The second group, with a strong real estate heritage, frequently comprises those skilled in real estate acquisition and management with a developed, but perhaps undocumented, track record. They often lack the ability to "speak the institutional investment language" and that precipitates their struggles to access institutional capital. This type of emerging manager frequently elects to enter the institutional investment management arena by designing and seeking capital for a fund. Often, prior experience is re-characterized as having included one or more "funds," such that the new offering can be described as the first "institutional" fund;
- Finally, the start-up or early stage organization frequently brings real estate skills, but lacks the broad range of capital formation capabilities and entity management skills necessary to effectively serve institutional capital providers. There is a natural progression to the growth of a real estate investment management firm.

The core team needs to demonstrate its real estate capabilities in some fashion in order to attract ongoing capital. One potential approach is to raise capital for a transaction (or several), demonstrating real estate investment and management capabilities. This can be followed by sourcing programmatic equity capital, allowing for the development and demonstration of discretion-in-a-box capabilities. During this period, as the investment portfolio grows and revenue increases, institutional infrastructure should be continually developed. Finally, assuming the emerging manager has performed well, the organization will be qualified to enter the fund management business should it so desire.

FINDING EACH OTHER IN A CROWDED MARKET

Finding each other in a crowded marketplace and initiating an appropriate dialogue is challenging for both investors and emerging managers. They don't necessarily occupy the same market space or share a common language. Emerging managers can recognize clear benefits from combining their real estate talent with institutional investor capital, so the issue for any emerging manager seeking institutional capital becomes how to best present its investment thesis, firm and real estate capabilities.

Investor Perspective

Initiating and overseeing relationships between institutional investors and emerging managers differs from working with established investment managers. Investors seeking to provide capital to emerging managers frequently have significant experience investing in real estate. Unfortunately, this is often a mixed blessing. An understanding of real estate investing and a thoughtful view of the attributes of a successful real estate investment manager is undeniably a valuable perspective. However, translating that knowledge into a successful selection process when not all desired attributes are present, which typically is the case for emerging managers, is not an easy task.

The challenge for institutional investors is to efficiently access the full universe of emerging managers to ensure they have the opportunity to partner with best-in-class. In this process, investors encounter numerous hurdles when initiating an emerging manager investment program. It is often difficult to identify those emerging managers most likely to succeed in both real estate investing and investment management and, while the investment opportunity may be sufficiently alluring to start the discussion, investors find that both underwriting and ongoing management of emerging manager relationships can be time-consuming relative to the size of the initial investment opportunity. Investors generally realize that mentoring is frequently necessary to protect their investment and support the manager's organizational growth. The need to balance investors' desire for appropriate control with the emerging manager's operating flexibility needs is often an additional challenge.

Few emerging managers will meet all of an institutional investor's capability and infrastructure expectations. Frequently they operate in an opportunistic fashion, tend to lack well-documented processes and practices (or operate differently from the existing documentation) and generally have limited internal research and administrative capabilities. To attract the support of institutional capital, emerging managers must provide comfort to institutional investors that their investment objectives will be met in a fiduciary environment.

Manager Perspective

Emerging managers often believe that the merits of their investment proposal and their capabilities are self-evident and so may struggle to comprehend why a single meeting fails to result in immediate funding. Against the backdrop of our discussion of investor challenges, what's an emerging manager to do? How should an emerging manager present its opportunity to institutional investors and how should the firm organize its business to maximize the likelihood that it will attract an institutional capital allocation?

Specific steps emerging managers can take to enhance the firm's attractiveness to institutional investors include:

- Develop a clear investment thesis. It should be supported by evidence that the team has considerable experience with the strategy and the target market(s).
- Present convincing evidence that the team has sustainable access to sufficient transaction flow for future investments. Investors must be persuaded that today's (relatively) small investment opportunity can grow into a program that provides returns impactful to their portfolio.
- Produce documentation of in-place processes that demonstrates adherence to well-defined underwriting and due diligence. Emerging managers must demonstrate compliance from the beginning, as any failure in disciplined adherence to planned processes likely will be viewed as a lack of appreciation for fiduciary responsibilities.
- Demonstrate the real estate operating capabilities of the senior team. It is preferable that the emerging manager provide a verifiable track record, but investors often can underwrite a firm's capabilities based on the prior experience of the principals. Emerging managers must accept that this type of due diligence will be extensive—and time-consuming. Investors will be seeking evidence that the team is likely to produce favorable returns from real estate value creation strategies.
- Present an organizational business plan that highlights platform viability. The investor effort to determine platform stability and financial viability is an opportunity, not an intrusion, as the examination will comfort the investor that the team will remain in place during the investment cycle. Investors expect a well-defined business strategy that incorporates fiduciary understanding and commitment.
- Meet institutional investor requirements for organizational infrastructure. Ideally, the emerging manager will build internal infrastructure prior to seeking institutional capital. Entities with existing businesses are expected to do this, and investors view this investment as a demonstration of commitment. However, this may be unrealistic for start-up and early stage emerging managers, as many are undercapitalized and have insufficient ongoing revenue to support a fully staffed organization. Emerging managers unable to initially build infrastructure because of capital constraints must develop a plan for outsourcing and managing necessary infrastructure required to operate the business.
- Engage or plan to engage institutional quality service providers including audit, legal, valuation and other professionals, as appropriate. This will help the emerging manager adapt to the communication, compliance and reporting requirements of institutional investors.

MEETING THE CHALLENGE

Investor Perspective

The challenge faced by an institutional investor in selecting emerging managers is identifying those that not only can successfully source investment opportunities and execute their strategy, but also understand and are committed to acting as investment fiduciaries. To tackle that challenge and invest with emerging managers, an institutional investor has two choices: 1) align or build a staff that understands the unique issues of emerging manager investing and has the time to devote to underwriting against smaller-than-average initial allocations; or 2) delegate program management to a specialized investment advisor or the investor's consultant.

Investing with emerging managers is more time consuming than working with established managers. Many institutional investors leverage their consultants' capabilities when developing and implementing such a program.

Key differences posed by investing with emerging managers include:

- The challenges for underwriting managers who do not possess a full-cycle track record of acquiring, managing and selling properties;
- The discomfort posed by potentially allocating discretionary capital to emerging managers despite less opportunity to observe their investment and management capabilities;
- The need for the investor to provide a portfolio management overlay as many emerging managers have a limited, and undiversified, investment focus;
- The need to provide ongoing mentoring or to participate in the oversight of the emerging manager's platform to maximize return potential and minimize risks;
- The smaller allocation size that can prudently be awarded to an emerging manager without overwhelming the firm's investment and management capabilities.

The investment selection process generally is practiced by the industry from the perspective of reviewing a track record to see how well the team has executed a strategy

similar to that proposed. Often emerging managers have a limited track record, making assessment of potential performance challenging. So to find the most suitable real estate emerging managers, underwriting requires an expanded approach, which needs to be exhaustive and is likely to be time-consuming. However, this lengthy underwriting process presents a side benefit. Investing the time necessary to underwrite a team without an established track record provides insight into: 1) the likelihood of successful execution of their strategy; and 2) the management and organization dynamics critical to the long-term viability of the emerging manager and the planned relationship. As emerging manager investing is as much about picking people as anything else, time spent to thoughtfully assess an emerging manager team's capabilities provides the opportunity to gauge how the manager will operate going forward.

Should the time commitment required to accomplish this type of underwriting overwhelm the internal staffing time constraints of an institutional investor, the use of an investment advisor or consultant may be preferable. Through an investment advisor, an institutional investor can access any number of emerging manager relationships with a single point of contact, providing greater diversification for a given investment of staff time and avoiding the need to manage relationships related to small capital allocations. These advisors have developed underwriting processes and procedures designed to identify those teams most likely to produce superior returns relative to their peers. An investment advisor skilled in working with emerging managers can provide ongoing strategic guidance and mentoring to emerging managers in building and developing their businesses to meet the expectations of institutional capital providers. The advisors are familiar with structuring risk management programs and controls such as retaining discretion over investment selection and instituting strict regulatory compliance and reporting standards.

An institutional capital provider, having made a decision to invest with one or more emerging managers, either directly or through an investment advisor, will need to consider the amount of investment discretion it is willing to provide to the emerging manager(s). It is logical to assume that an institutional investor would grant less discretion to an unproven investment manager than to an established manager with a proven track record. However, one of the key advantages an emerging manager can offer is a first mover advantage gained through deep involvement with a property type and/or relationships within a geography. But to use this advantage, the emerging manager must be able to react timely to opportunities uncovered. Complicating the decision regarding the correct amount of investment discretion to provide the emerging manager is the fact that many of them, as local operators, have a specific property type, geographic, property life cycle and/or risk profile focus that is inherently undiversified. While the specificity of focus is often the reason for investing with a particular emerging manager, the institutional investor or its consultant or advisor will need to add a portfolio management orientation to the construction of the investment portfolio to manage concentration risk.

To fully benefit from establishing a relationship with an emerging manager, the institutional investor should strive to structure its relationship so that constraints exist at the level of the program structure, leaving flexibility to react to specific investments by the emerging manager. In other words, define the expected investments in any way desired and then allow the emerging manager to make investment decisions as long as the investment fits predefined criteria. Should an institutional investor want to participate in decision making at time-sensitive points, sufficient internal staffing should be available to do so without impairing timely execution. If staffing is not sufficient to assure this, it may be advisable for an institutional investor to work through an advisor structured to effectively interact with emerging managers.

Most emerging managers are small firms and do not possess the full suite of underlying capabilities generally required of managers to which institutional investors allocate capital. An institutional investor applying its typical manager assessment criteria often will inadvertently screen out most emerging managers. To establish an emerging manager program, an institutional capital provider likely will need to temporarily alter or waive certain standard organizational or non-real estate-related manager underwriting requirements. The key is to define the screens in a manner that allows only those emerging managers that meet the minimum prudent requirements to pass through.

Other standard requirements, desired but not critical, can be set aside temporarily during the initial stages of the relationship or achieved through other means. For instance, generally an institutional investor will expect a manager to have adequate research capability to identify and assess investment opportunities. As long as the emerging manager can demonstrate access to the

information needed to provide a broad and localized economic back-drop and information regarding local property market conditions, the institutional investor should accept that the emerging manager accesses broader market research through third parties. Similarly, accounting and investor reporting can be outsourced to third parties or provided, in part, by a specialist investment advisor as part of the advisor's mentoring and business development assistance for the emerging manager. This frees the emerging manager from allocating its scarce operating resources to non-investment functions until its revenue stream develops sufficiently to incorporate qualified research, finance and accounting functions in-house. Generally, institutional investors have not needed to relax their underwriting standards in order to do business and so doing can pose internal approval issues that investment staffs may not be willing to recommend.

Compounding the challenges of considering an emerging manager investment program are concerns regarding investment platform viability. Less developed than established managers, emerging managers pose an additional risk to institutional investors—that of enterprise viability:

- Will the newly established team work well together?
- Does the firm have a credible financial plan showing adequate resources to operate and grow its business?
- Will it achieve sufficient success to retain its key principals?
- Will it generate sufficient revenues to fund the growth of the business?

Each of these issues must be carefully evaluated as their impact on the success of the program can be as critical as the investment strategy (i.e., the best deal may be only as good as the people executing it).

To offset the challenges and risks, investors must require emerging managers to demonstrate that the investment dollars allocated have a unique opportunity they would not have in the hands of established managers.

Manager Perspective

Emerging managers seek institutional capital primarily to secure access to reliable, competitively priced equity capital which enhances the manager's ability to be competitive in securing the best investment opportunities. It is challenging for emerging managers to attract the attention of institutional investors overwhelmed with available investment program opportunities through a substantial roster of managers. To do so requires a compelling investment thesis and detailed execution plan that offers an opportunity not readily available from known, established investment managers.

As described above from the point of view of an institutional investor, investment advisors/consultants can play a role in an emerging manager's business process. Rather than directly approach and secure an allocation from an institutional investor, an emerging manager can receive an allocation through a specialist in emerging manager investing. Prior to making this choice, an emerging manager should become familiar with how an advisor can improve the manager's chances of success in the capital formation process. Largely this choice between a direct approach and working through an advisor will depend on two issues: 1) the time the emerging manager has available to source investment capital; and 2) the extent of the firm's organizational infrastructure, including understanding of and relationships with institutional investors.

The lengthy time commitment to directly access institutional capital, which can require 18–24 months or more, may be too great for an emerging manager that would prefer to focus on its investment business. The alternate method an emerging manager can choose is to seek capital through an investment advisor operating an active emerging manager/joint venture investment program. Generally, investment advisors can provide an indication of potential interest or non-interest quickly, making capital sourcing through an investment advisor potentially more efficient than attempting to source capital directly from institutional investors.

Emerging managers often start as real estate operators and investors. As they begin their interaction with institutional investors, they find themselves needing to incorporate the expected fiduciary orientation. This requires very different business skill sets from those of real estate investing. Becoming an investment management fiduciary often requires developing conflict management procedures, and includes meeting institutional capital providers' requirements for investment underwriting diligence and investor communication and reporting. This is not to suggest that all emerging managers must internalize all of the various roles and responsibilities of investment fiduciaries. Some may choose to retain a single-minded focus on investing and value creation and leave portfolio management and fiduciary oversight to the institutional investor's staff, its consultant or an independent investment advisor. In some

fashion, however, emerging managers must be able to convincingly demonstrate that risk management and control processes are incorporated into all aspects of the firm's decision making and operation. An independent fiduciary, consulting firm or outside advisor can provide valuable guidance for emerging managers uncertain about institutional infrastructure requirements. These experts can guide the manager in best practices that will help build capabilities to expand the business platform, formulate investment strategy and strengthen portfolio management. Such mentoring can accelerate the maturation of an emerging manager into a self-reliant institutional capital investment manager capable of satisfying fiduciary operating expectations.

The investment selection process practiced by institutional investors is a key component of operating their investment platforms and receives substantial time and attention from their investment staffs. Faced with the challenge of underwriting emerging managers, it is understandable that an institutional investor may choose simply to direct its capital to established managers having track records to underwrite. To overcome the automatic elimination generally associated with not having a track record of prior performance, the emerging manager must present a strong case for its investment skills. A "me-too" plan will not provide a rationale for an institutional investor to choose an emerging manager over an established manager offering a similar investment strategy.

The emerging manager seeking capital from an institutional investor will need:

- a business plan that includes a clear investment thesis supported by convincing evidence that the team has sustainable access to transaction flow for future investments;
- in-place processes that demonstrate adherence to well-defined underwriting and due diligence policies and procedures;
- a successful track record in the specific strategy being pursued, either as part of the current organization or as part of a previous organization;
- evidence that the senior team has considerable operating capabilities, backed by a successful track record in the specific strategy being pursued, and evidence of an ability to maximize returns through value creation strategies; and
- an investment and organizational development plan that demonstrates fiduciary understanding and commitment in all aspects of its proposed operation.

Assuming success in garnering the interest of an institutional investor or appointed advisor in allocating capital, an emerging manager must demonstrate enterprise viability and present a credible financial plan that shows adequate resources to effectively invest and manage the capital allocated and to operate and grow its business. A component of proving overall platform viability is demonstrating financial viability. Meeting the demands placed on managers for real estate operating and investment management capabilities is an expensive proposition for an emerging manager. Often the emerging manager is undercapitalized and the revenue stream from an initial allocation of institutional capital is insufficient to cover required overhead, even if the institutional capital provider agrees to relax some typical requirements. While it would be difficult for an emerging manager to suggest it should receive higher fees than appropriate for an established manager executing a similar program, the emerging manager may seek to accelerate revenue to support the development of its institutional service platform. Receiving compensation earlier in a program than might be typically approved by an institutional capital provider may position the emerging manager to grow its internal infrastructure in a fashion supporting investor interests. The accelerated revenue need not be incremental. In exchange, the emerging manager can offer a number of benefits such as an exclusive relationship that provides certain access to the manager's unique pipeline of investment opportunities; a higher preferred return on the institutional investor's capital; forfeiture of any general partner promote catch-up; a reduced share in the investment profits generated; or any other negotiated relationship that is mutually agreed.

Those emerging managers that can meet the demands of institutional capital providers and are awarded an allocation have passed through numerous capability screens. As a result, they have demonstrated an investment thesis and operating plan that position them as best-in-class, next generation real estate investment managers. Those that can meet the stringent requirements likely will find institutional investors and their advisors/consultants willing to adjust their practices and requirements to take advantage of their skills.

CONCLUSION

Who or what is to blame for the limited capital allocation to date of institutional capital to real estate emerging manager firms? It seems apparent that both sides should consider taking steps to facilitate an increase in such

allocation. Emerging managers must demonstrate something of value that cannot be obtained through established managers. Institutional investors need to modify their internal processes to accept and support allocation of capital to those that can become the next generation of real estate investment managers.

There is no question that institutional investors pose high hurdles for emerging managers, but setting a high bar is appropriate. Institutional investors may be willing to temporarily modify their rules and requirements to facilitate allocating capital to those emerging managers that make it through their screens. It is unrealistic to expect to allocate capital to emerging managers if an institutional investor does not permit flexibility in its requirements for organizational infrastructure and internal capabilities.

Institutional investors offer emerging managers access to reliable, competitively priced capital. In return, emerging managers offer institutional investors economic and non-economic benefits not available through traditional established managers. The industry as a whole benefits as a greater number of capable investment managers are funded to offer a wider array of potentially successful investment opportunities.

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