A Reprint from *Tierra Grande*

PRIVATE EQUITY

By Cydney Donnell

DJIA 13422.77 ▼ 294.26 –2.1% **NASDAQ** 2652.35 ▼ 2.4% **NIKKEI** 16044.72 ▲ 0.8% **DJ STOXX 50** 3783.36 ▼ 0.6% **OIL** $90.02 ▲ $2.16

Transforming Institutional Investment Strategies

Equity capital for real estate investment historically came from wealthy individuals, but as commercial real estate markets developed after World War II, sources of equity capital began to shift. In the 1950s and 1960s, life insurance companies were predominate sources. Passage of ERISA laws regulating pension funds in the 1970s encouraged these institutions to diversify further and add real estate to their investment mix.

An investment binge by pension funds in the early 1980s and the real estate bust later that decade opened the door for public equity in the form of REITs. At the same time, the insurance industry began to exit equity real estate, leaving this investment area to other capital sources.

Today, major equity investors include individuals, REITs and pension funds. They have one commonality: the pursuit of competitive, risk-adjusted returns.

As real estate began to offer competitive returns with less risk than stocks, the industry attracted huge inflows of investment capital. This caused yields and expected returns on real estate to decline because massive pools of investors were bidding on the same assets. Not surprisingly, investors now seek new investment strategies to increase expected returns.

Real Estate Advisory Industry Restructuring

Investing in real estate can be a challenge for institutional investors. Few pension funds or other institutional investors such as endowments and foundations have adequate funding to staff large research and investing departments. Consequently, they outsource these activities to investment firms.

Traditional pension real estate advisors include Prudential, RREEF, Jones Lang LaSalle and Heitman. Many companies that began as brokerage firms have entered this market, including Cushman Wakefield and CB Richard Ellis. Some real estate newcomers with Wall Street roots, such as Goldman Sachs and Lehman Brothers, offer funds as do classic buyout firms (called private equity firms) such as Blackstone. More and more firms are entering this arena.

The responsibility of identifying ap-pro-priate investments, monitoring the in-vestments during the holding period and disposing of the investments is outsourced by institutional investors to these real estate advisors. Functionally, they have investment divisions and asset management divisions. Property management may be provided but often is outsourced to a third party.

Real estate investment advisory firms have been forced to change their business models to accommodate the pension fund industry. For example, pension funds no longer accept a flat fee on asset value as they did in the 1980s. Under that structure, advisors had no incentive to worry about the success of the investment. They were concerned only with increasing the assets under their management. Today, advisors usually receive rewards for successful investments. For example, they may be permitted to co-invest with the funds or they may receive incentive fees when the investments are sold.

Not surprisingly, the new model for equity real estate mimics successful investment structures private equity firms such as Kravis Kohlberg use.

Pension investing originally was structured around sole or joint ownership of fully leased property. This low-risk

Institutional Investors

Institutional investors are entities with large amounts of money to invest, such as insurance companies, mutual funds, pension funds, foundations or endowments. They are led by investment professionals and are considered sophisticated investors. They have fiduciary responsibility to other smaller investors, such as the mutual owners of the insurance company, the shareholders of the mutual fund, and the beneficiaries of the pension fund, foundations and endowments.

investing, called core investing, no longer provides institutional investors with high enough returns to meet their pension obligations, so funds have had to expand the kinds of investments they will consider. To increase returns, pension funds and their advisors have embraced investment structures long used by the mainstay buyout firms along with new investment strategies that may not be familiar to most real estate developers and investors.

Real estate entrepreneurs are increasingly forced to turn to various institutional investors, including pension funds and their advisors, for capital. Understanding the goals and investment strategies of the various types of funds is one key to sorting through the myriad investment products in the marketplace.

Core Investments

Core investments are characterized by a long-term strategy (holding property for ten to 20 years), stable income and minimal active management requirements (management involvement and expertise is less critical because of the duration of the leases). Return expectations historically have been 12 percent but more recently have been in the 7 to 10 percent range. Core investments include:

- publicly traded REITs,
- tenant sale/leasebacks,
- substantially leased multitenant commercial properties with long-term lease maturity schedules and
- senior secured mortgage lending.

For small institutions, public REITs may represent their entire allocation to real estate. As institutions increase in total asset size, public REITs may be used for a portion of the core allocation, to temporarily manage cash awaiting other investment opportunities or as a leading indicator of the valuation changes of private real estate.

Core investments may also include strategies of investing in senior secured mortgages. These mortgages are viewed as low risk because they are senior to all other claims to the property, often have a loan-to-value ratio less than 70 percent and may have an investment grade rating of BBB or better. A mortgage investment may be a single asset or "pooled" — several mortgages combined into a single security.

Value-Added Investments

Conceptually, this strategy seeks a higher return than a core strategy. It usually involves investing capital and management time subsequent to the initial investment. The investment horizon is generally medium term (three to five years). A value-added strategy generally produces an income over the life of the investment but expects a portion of the overall return to come from the successful sale of the investment. Targeted returns typically range from 12 to 15 percent with 6 to 8 percent derived from income.

Management capability and expertise is critical in a value-added strategy. Examples of value-added investments include equity investments in commercial real estate, structured real estate financial products and mezzanine financing.

Equity investment in commercial real estate seeks properties in need of redevelopment, repositioning or recapitalization to improve operating income and value. Properties may be acquired as sole ownership or joint ventures with experienced operating partners. Leverage ranges from 50 to 75 percent loan-to-value ratio. Geographically limited to the United States, these funds will sometimes venture beyond major metropolitan areas to secondary markets.

Structured real estate financial investments are often subordinated loans created from real estate debt portfolios such as commercial mortgage-backed securities (CMBS), REIT debt and real estate collateralized debt obligations (CDOs). Fund managers seek to invest in complex, "mispriced" securities that the investing public may not fully understand. They may use financial leverage to achieve their

Collateralized Debt Obligations

Collateralized Debt Obligations (CDOs) are asset-backed securities. The CDO invests in a pool of cash-flowing assets such as car loans or real estate. Cash flows are then paid out to investors based on a priority schedule. These schedules are known as traunches. The traunch that receives cash flow before any other is usually investment grade rated AA or AAA. Subsequent traunches receive lower priorities and ratings with the lowest classified as junk or equity rating. Conversely, losses are applied first to the lowest ratings. The term "commercial real estate CDO" usually refers to a security backed by REIT assets.

return objectives. For example, they may seek to match fund securities by issuing a CDO with the fund retaining the CDO equity. These investments typically require greater real estate knowledge and analysis capability than traditional fixed-income portfolio managers may possess because the debt may be unrated, underperforming or both.

Mezzanine financing, a hybrid of debt and equity, uses a strategy of investing in debt or preferred equity with equity participation or conversion rights. The typical investment horizon is short term — less than three years. Mezzanine interests typically are subordinate to first mortgages and senior to traditional equity. If the mezzanine loan is not repaid, the lender usually converts the investment into an ownership position. Management must be talented in structured finance and extremely knowledgeable regarding tax law.

Opportunistic Investments

These are the most intricate investment strategies. A high portion of expected return comes from the sale of the property and may or may not include any current return. Higher leverage is employed, thus increasing both risk and potential returns. Management must be talented in finding investment opportunities because properties acquired through auctions typically conducted by real estate brokers are competitive and often will not produce required returns.

Opportunistic fund investments are more complicated because of financial, regulatory or tax requirements. They require expertise in structuring complex transactions and in asset/property management. Funds in this category generally target returns exceeding 15 percent. Some strategies employed are:

- asset and portfolio acquisitions,
- redevelopment projects,
- development projects and
- real estate operating company investments.

Asset and portfolio acquisitions involve buying single assets and entire portfolios of real estate. Portfolios may have disparate product holdings located all over the globe and may include fee simple holdings, partial interests in real estate or varying mortgage ownerships including subordinated loans. In many cases, this strategy includes re-selling individual assets in the portfolio to other investors.

Redevelopment projects may involve assets that have been neglected by an owner because of poor capitalization or lack of expertise. Value enhancement may be achieved by upgrading the asset quality or changing its use or design, which ultimately improves the property's financial performance. This process may be more difficult if desired changes include obtaining entitlements.

Development projects require identifying shortages in a market and accepting the inherent risk of creating a new project. While new development opportunities may be somewhat limited in the United States, many other countries lack modern facilities. Typically, funds enter into joint ventures with partners who have local knowledge and experience.

Real estate operating company investments are those that finance or recapitalize businesses providing real estate–related services or companies that own real estate assets. Examples of service providers include hotel operating companies, specialized mortgage lenders or property management companies. Buyouts of publicly traded companies such as REITs fit into this category as well.

Real Estate Fund of Funds

The strategies discussed previously are suitable only for the largest of institutional investors because a minimum investment of $5 million to $10 million per investor is required. A real estate fund of funds (FOF) assists smaller institutions (those with $25 million or less allocated to real estate) in diversifying their investment strategies.

An FOF pools investor funds and invests in real estate opportunities representing multiple strategies. For example, ten small institutions might combine their money to meet the minimum investment required by the FOF. The FOF then contacts existing fund managers to build an interesting mix of investment strategies. An asset management fee is added to compensate the fund manager in addition to the underlying fund fees. At this time, few opportunities exist to invest in fund of funds. However, interest in this product has been growing.

The challenge for today's institutional real estate investor is determining the investment strategy that meets its desired risk and return targets. Real estate firms hoping to become investment managers for these institutional investors must understand these needs, the competition and the fund structures to successfully raise capital in the institutional marketplace.

Dr. Donnell (cdonnell@cgsb.tamu.edu) is executive professor of finance and director of real estate programs in the Mays Business School at Texas A&M University.

THE TAKEAWAY

Private equity firms have transformed the ways institutional investors invest in real estate. Core, value-added, opportunistic and fund of funds investments use different strategies to produce competitive, risk-adjusted returns.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

Director, Gary W. Maler; **Chief Economist,** Dr. Mark G. Dotzour; **Communications Director,** David S. Jones; **Associate Editor,** Nancy McQuistion; **Associate Editor,** Bryan Pope; **Assistant Editor,** Kammy Baumann; **Art Director,** Robert P. Beals II; **Graphic Designer,** JP Beato III; **Circulation Manager,** Mark Baumann; **Typography,** Real Estate Center.

Advisory Committee

David E. Dalzell, Abilene, chairman; D. Marc McDougal, Lubbock, vice chairman; James Michael Boyd, Houston; Catarina Gonzales Cron, Houston; Tom H. Gann, Lufkin; Jacquelyn K. Hawkins, Austin; Barbara A. Russell, Denton; Douglas A. Schwartz, El Paso; Ronald C. Wakefield, San Antonio; and John D. Eckstrum, Conroe, ex-officio representing the Texas Real Estate Commission.

Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin.