

A Conversation with Stefan Hepp

*The real estate and private equity investment consulting firm SCM Strategic Capital Management AG, headquartered in Zurich and with offices in London and Hong Kong, recently published its first annual review of private equity real estate terms and conditions. The main findings are detailed in the box story on page 26. The past couple of years have not been good ones for investors in unlisted real estate funds. Questions have been asked, the answers to those questions have not always been what people wanted to hear or receive, and relationships between investors and fund managers have come under strain. Editor **Richard Fleming** spoke recently with SCM's founder and CEO **Stefan Hepp** about the review's findings and the wider implications for real estate investors and fund managers.*



Stefan Hepp

We know that investors are not happy with the way things turned out. What prompted you to undertake the review?

We work in the private equity and real estate business. We do a private equity terms and conditions study, and this is now in its eighth year. The private equity real estate terms and conditions study is basically a sister study that covers the real estate base.

Were you surprised by any of the findings?

We were surprised by a number of them, starting with the deal flow. We found a lot of first-time funds: in 2009, these represented more than half of all the funds reviewed. You wouldn't expect that in such a difficult fund-raising environment; it takes extra bravery if you are not an established player to go out in the market and seek money from investors. One would have expected fewer first-time funds, but that didn't happen — the numbers were the same as 2008 and only marginally different from 2007, which is baffling.

It's partly down to other trends that are unfolding in the industry. For example, a number of the more established players are getting shaky, shall we say, so people are leaving these organisations and trying to set out on their own. This real estate crisis is breeding new management teams. Not all of these new management teams are new to the asset class — they have worked in other organisations and are now deciding that it is time to jump ship and strike out on their own. That was one of the findings that surprised us.

Another finding is not that surprising if one follows what is happening in the banking sector. The number of captive funds declined either because many of the sponsors don't exist any more or because they can't support new fund offerings anymore. That leads to a decline in that type of fund, with captive team and sponsor behind it.

So, first-time funds are still prevalent. People are leaving established players and branching out on their own. But a period like this downturn is exactly the time when investors are not willing to go with fund managers who don't have track records.

Yes, and that's what makes this study a little bit special. The problem you have when you analyse terms and conditions is that, in terms of deal flow, you review a lot of fund offerings and those fund offerings are a meaningful indicator of what's going on in the industry. Normally you can rely on the fact that at closing time the terms are broadly similar to those offered initially, but that's not the case in this environment. A lot of the fund offerings that we looked at have not closed anything yet or only minimal amounts. The ones that we are involved in and see on a day-to-day basis have had to make substantial concessions to get their funds raised. We could just have presented statistical data to paint a picture saying basically nothing has changed or not a lot has changed. A lot of these fund prospectuses and offering memoranda were still copy-pasting from

“The debt crisis that is still unfolding in the commercial real estate market ... has hit fund managers like a tsunami.”

the past, going out with terms that were OK two or three years ago but that will not now lead to a fund closing because investors won't accept the terms and conditions. We therefore presented our insight on how the negotiations in these funds were going in order to draw a realistic picture of the current market environment.

So, sentiment as well as fact?

We see too many facts to call it “anecdotal” evidence, but I also wouldn't say that we see enough facts to claim statistical significance

Tender Terms, Harsh Conditions

It's tough out there. SCM Strategic Capital Management AG's first annual review of private equity real estate terms and conditions shows clearly how things have changed in the real world over the past couple of years.

The cyclical downturn in real estate markets coupled with the impact of the financial crisis and credit crunch have revealed tensions in the relationships between investors and fund managers. The cosy co-existence of years past, when returns were high and above expectations and when few questions were asked, has been replaced by a harder edged relationship where investors seek to lay out in detail what they expect from fund managers in terms of performance, transparency, alignment of interests and corporate governance, what they will pay for and how much they will pay.

The SCM review covers the period from 2007 to 2009 and looked at the terms and conditions for a sample of 329 closed-end private equity real estate funds that were on offer in that period. The data sources were the terms and conditions as outlined in real estate offering memoranda and not negotiated terms from limited partnership agreements. Here are the main findings of the SCM review:

- The geographic focus and distribution of the 81 funds in the 2009 sample was 53 percent for North America, 25 percent for Europe, 16 percent for Asia and Rest of the World, and 6 percent for global funds. This showed a shift in the geographic distribution for the 81 funds in the 2007 sample away from Asia and Rest of the World (2007, 36 percent; 2009, 16 percent) and toward North America (2007, 36 percent; 2009, 53 percent). The share of smaller funds, defined as smaller than \$500 million (€370 million), increased from 50 percent in 2008 to 68 percent in 2009, and the proportion of debt funds rose from 7 percent in 2008 to 21 percent in 2009. The majority of funds are still opportunistic.
- The investor base has fallen back. The retreat of US investors, previously large capital allocators to real estate funds, had a major impact on the 2009 fund-raising environment. Another large investor group that remained largely inactive last year was that of sovereign wealth funds. Reliable indications about post-Lehman Bros terms and conditions are not yet available as funds that started fund-raising in 2009 have yet to report a significant first close. (Those few funds that announced a significant first or final close in 2009 started fund-raising in 2008 under "old", pre-Lehman terms and conditions.)
- Fund managers who launched funds in 2009 "certainly understood that they could not just copy-paste the terms and conditions from their last funds, which were raised in a different market environment," says SCM. Fund managers are not entirely clear what terms investors will accept; some reacted by amending some of the terms and conditions in the offering memorandum, leaving others for subsequent discussion and negotiation in the limited partnership agreement.
- The carried interest, ie. the proportion of the profit on fund investments that flows back to the fund manager, of most funds stood at 20 percent. Some fund managers attempted to introduce a performance-related system — for example, 20 percent carried interest if a preferred return or hurdle rate of 8 percent is achieved, rising to 25 percent carried interest for a 15 percent preferred return. In SCM's view, the initial hurdle rate has to be higher than 8 percent if performance is to play a formal role.
- The waterfall, ie. the order of priority in the distribution of fund proceeds, has become more favourable to investors. Almost 60 percent of funds now return paid-in capital plus a preferred return to limited partners before the fund manager would be entitled to receive carried interest.
- Management fees were of less concern to investors in the pre-2007 period of high returns. Today is different. An increasing proportion of funds, 15 percent in 2009, charged management fees on invested capital from the beginning rather than on committed capital; this has the effect of reducing the level of fees charged during the commitment period. SCM points out, though, that this could encourage the fund manager to deploy capital more quickly so as to maximise fee income. It believes that a lower management fee would be more effective than a change in the management fee base. The lack of meaningful fund-raising activity means that firm evidence on management fee trends is scarce; anecdotal evidence, however, suggests that investors are seeking lower management fees.
- The investment period and investment term for real estate funds are normally three to four years and eight years, respectively. The 2009 fund sample saw 22 percent of funds with an investment period of less than three years and 42 percent with an investment term of less than eight years. This is attributed to the higher proportion of private debt fund offerings last year, as debt funds generally have a shorter life. Of the 18 private debt funds reviewed in 2009, 56 percent had a fund term of less than eight years and 39 percent had an investment period of less than three years.
- The use of placement agents declined. Although one might expect fund managers to use placement agents more in a difficult fund-raising environment, SCM attributes the reduced involvement of placement agents to a commercial decision on their part not to accept mandates where the chances of success are regarded as slim. Some placement agents changed their business model from a pure success fee to a mix of retainer and success fee.
- Investors want to see fund managers deploy more of their own capital and bring about a better alignment of interests. The use of fund management fees, property management fees and capital from other businesses of the parent company to cross-subsidise fund manager co-investment capital raises doubts in investors' minds about the real alignment of interests, says SCM. Some fund managers' business models could falter if the method of fund manager capital input has to change.
- Other areas where SCM believes that investors will exert greater pressure on terms and conditions include fund manager removal with or without cause, key-man events, and the role and power of the advisory board. The balance of power has shifted in favour of investors, it says; "most fund managers who intend to raise new blind-pool funds will have to make significant concessions on the terms and conditions of their offerings if they want to have a realistic chance of closing a fund."

Further details of the SCM review can be obtained from Mirjam Aeppli, business development manager, SCM Strategic Capital Management AG, Zurich, tel: +41 (0)43-499 4949, e-mail: aeppli@scmag.com.

— Richard Fleming

on this in the strict scientific sense. We've given our views on what we're seeing, trying to make sure that the review paints a picture that is an accurate reflection of what's going on in the marketplace at the moment.

“Even when the severity of the problem became apparent, a lot of fund managers failed to own up to their investors and tell them that they had a serious problem.”

The period from 2007 to 2009 is a period that most real estate investors would rather forget, but it is undoubtedly the case that periods of downturn sometimes reveal shortcomings that would not otherwise become apparent. What shortcomings have been revealed, and what lessons can investors learn from what has happened?

The debt crisis that is still unfolding in the commercial real estate market, which is more relevant to institutional investors than the housing market, has hit fund managers like a tsunami. And it has also blurred the distinction between reckless and cautious behaviour. For example, the differences in leverage ratios between people who are sailing on the edge and people who are more modest have been outweighed by the change in the funding environment. The principal shortcoming that this has revealed is one of communication. Even when the severity of the problem became apparent, a lot of fund managers failed to own up to their investors and tell them that they had a serious problem. I could show you statements from fund managers who were saying that “all is going to be fine in 2015” or something like that, that “this is just a blip for a year or two before we go back to the old normal of 2007”. People were not owning up or facing reality, and this led to communication with investors that was not

credible. And if communication is not credible, it eats into the credibility of the fund manager. We have also seen some fund managers struggle with the sheer amount of work that flows from issues and challenges surfacing almost simultaneously in many of their underlying investments.

When I say “some fund managers”, I want to single out a business model that has, as a result of the boom, flourished in the real estate market and that is what I call the “asset gatherer”, organisations that have invested in multiple markets with little or no operational resources, basically collecting capital from investors and investing it in joint ventures with local players. Now, in this environment, when many of these deals have become “challenged”, you have to play your ownership role, even in a joint venture, and it turned out that some of these organisations had neither the manpower nor the depth of experience to address those challenges.

They didn't have the skill?

They sometimes lacked the skill, and they had no depth, no roots — a combination of the two, with the lack of local resources probably being the more important issue. The two shortcomings are usually exposed together when organisations are simply overwhelmed by the size of the problem.

So where do investors go from there? They learn not to go with such fund managers?

I think investors at the moment are shell-shocked. The big ones, like the large US pension funds, in particular the state pension funds, and some of the sovereign wealth funds, have been absent from fund raising, and that's a significant reason why there have been so few funds closing. Our clients are very happy to continue investing according to plan, but that can't happen if the others don't do the same. The funds cannot close. What we're facing now, when we do our due diligence on funds, is we say “OK, we'll consider the fund once it has reached a certain size”, but it never reaches the size, therefore we don't consider

the fund. It's a chicken-and-egg problem. US pension funds have retreated from real estate because of the sheer scale of losses that they incurred on their property portfolios domestically. They are in the centre of the storm of the real estate crisis. They are facing the prospect of further big write-offs; combined with the general market downturn, this has caused overall portfolios to shrink. The general lack of liquidity has caused all sorts of cashflow issues, and the appetite to add more of anything that is illiquid has gone. Property falls into that category.

The sovereign wealth funds have different issues. They actually plan to invest lots of money in real estate, and they often sit in jurisdictions where the build-up of a sizeable home portfolio is not an option, so they are by definition internationalists. They question whether it's wise to give €500 million or whatever to an individual fund in one ticket; a large sum to a closed-end vehicle that is illiquid over many years and where they have little control over the fund manager and the risk profile. They think about what model they should apply in the future, and there are various trends emerging — one is segregated accounts, which give investors more say over individual transactions, and the other is a stronger hand in co-investments or a stronger share of co-investments where you basically put some money into a fund but you plan to deploy significantly more money parallel to the fund in individual transactions. This is like pick and choose; it's driven by the same desire to have more control over the type of investment you get.

It sounds like control is the key word. What other changes do you see taking place?

I think many of the fund managers in Europe and the United States face a change in their business model. The lack of available debt today requires a totally different skill set than the traditional real estate manager. Real estate investing today is about asset financing and sorting out the debt problem associated with a property or even getting ownership of the property

through debt purchase. It's not so much revamping of property and adding value by repositioning it. Fund managers are under tremendous pressure to adjust their skill sets to the new environment — you could say, you don't need architects and developers at the moment, you need bankers and credit specialists to execute a strategy.

Some people would say it's the financial engineers who got us into this mess in the first place.

Maybe. But if the fuse in your house blows, you don't call for the plumber! It's an electrical problem — you call an electrician. People can be derogatory about financial engineering, and, yes, financial engineering did contribute in various ways to the crisis we're in. But if you're a real estate manager today and you want to buy property, let's say in the United Kingdom or United States, you need to have people who know debt very, very well in order to do so.

Have fund managers yet fully understood how the investment environment has changed, that the balance of power has shifted toward investors? Have they made sufficient allowance for the harder investor determination to bring about better corporate governance, greater transparency and a better alignment of interests?

As Charles Darwin suggested, the ones who adapt best, survive! I believe some of them have perfectly well grasped not only the challenges but the opportunities that this environment provides. They've got the necessary resources or are making the necessary adjustments. Others are still hoping for some miracle recovery. They're not treating this as a fundamental change in the way of doing business; they hope it's a cyclical thing that's going to be reversed over 12–18 months. The picture is mixed.

So the people who can adapt best are the people who survive?

Yes. Quite a few fund managers are so overwhelmed by the problems they have now that they're not thinking so much about what the

future business model is going to look like. They are worrying about something different — are they still going to be around in 2011?

Investors are reportedly resisting investment management fee structures that involve "paying for this, that and the other." That may have been acceptable in a high-return environment, but isn't now. Equally, fund managers need remunerating and an incentive. How do you see the fee environment evolving?

Many fund managers who started institutional funds came out of either joint ventures or direct. They had high promotes in their assets, in some cases higher than the 20 percent carried interest, and they didn't have such a high fee base. Then the model was changed to one where the fees became more important and the promote was still quite high, 20 percent, but basically copying terms and conditions sheets from the private equity industry. That's fine, when things are going up. It's not fine if you're in a downturn. Imagine a building, compare it to a company, and talk about cost cutting, generating free cashflow, paying down debt.

In a company, you have many more buttons that you can press to make this happen than in a building. You can discontinue certain products, reduce your inventory, downsize the labour force — you can save on a lot of things to improve your operating margin. On a building, that's not possible — you may be able to delay an upgrade investment programme, you may cut a little bit of administration cost, but that's only going to give you 50 basis points. You're not talking percentages here. If you're in a building that has a cap rate of 4.5 percent and find you need 7 percent, there is no way you can get that through cost cutting, impossible.

And that is the big problem with the commercial real estate fund industry. It has a fee-and-promote model that in private equity may survive the downturn because they have more ways to hold on to their assets, there will be fewer cases where they lose their assets. But in real estate there are funds out there that may

not be able to hold on to a single asset in the fund. This is now dawning on investors, and so they are saying "OK, if that's the case, we have a different risk profile, and there are two things that we have to do about this."

Either they go for the bull market concept — give these guys money to run a trend, go for huge price appreciation. I don't think any investor would choose this strategy at the moment. Or the other thing is, and this is happening more at the moment, that the fund manager is forced to adopt a more conservative risk profile. What that means is much lower levels of leverage; there are funds that have a ban on leverage so they do equity-only deals. Now if you do this, then you are in single-digit returns, even in good times, and you cannot charge a 2 percent management fee and 20 percent carried interest on something that proposes to outperform the bond market by, let's say, 250 basis points over the long run.

When do you expect the fund-raising environment to improve?

Not before 2011, maybe 2012. But why are investors still so bearish? We are actively looking for fund managers who can close funds because we believe this environment is going to be a bonanza for investors.

"If I say funds are going to lose many of their investments, lose them to whom?"

Is it likely that the changed investment environment will see a move away from the "them and us" attitude that seems to have developed to one involving mutual investor/fund manager recognition of shared and common interests?

In some firms, yes; in others, no. In some situations, it is not any more about having a long-term working relationship but about a sort of wind-down relationship.

Where you have a situation that is more or less a liquidation or a write-off situation, people tend not to be too happy with each other's company. In other situations, where fund managers are looking better, where they have a better handle on the issues in their portfolio and where they are regarded by the investors as the sort of people they want back in the future, the atmosphere and the conversation and the spirit of co-operation is much better.

“Investors are thinking about the future, how to benefit from the sell-off in this asset class ... and who to work with.”

Investors do understand that the real estate industry has, to some extent, fallen into an extraordinary hole. The fact that fund managers may not make any money on recent investments will neither deter investors from believing that real estate will continue, as it has for many decades and hundreds of years, to be an interesting asset class and that they need to have fund managers who understand the business and invest the money for them, particularly if they want to invest internationally. This basic notion is not going to go away; there is still this sort of rock-bottom belief that you want to be in real estate in the long run. With inflationary fears on the rise, this trend could well accelerate.

There is also a recognition that the problem of this order of magnitude that we have today must also create extraordinary opportunities just to unwind all this financing. If I say funds are going to lose many of their investments, lose them to whom? The banks won't take it all back on their balance sheets. There will be buyers out there who will benefit from this. Investors are thinking about the future, how to benefit from the sell-off in this asset class, how to survive with existing investments in the crisis, and who to work with in the future. There will be a number of players who

won't make it. They will not be around in future.

We've seen the industry go through an exciting time of heady growth and yield compression and an equally exciting time of poor investment performance, disappointed investors and fractured investor/fund manager relationships — were the warning signs there for you?

Of course. Things like the condo-boom in Florida, where people were buying on a mortgage, using the price appreciation on their first apartment and leveraging up — this wasn't sustainable, and this was clear to a lot of people. In any asset market, you always have people who work on the premise of the lesser fool. It's going to last for another six or 12 months, so let's make an extra buck before it ends. That does not mean they are not all realising that what's going on is not going to last forever.

So I guess there was an understanding of that kind when London buildings were going for cap rates barely above government bonds, or even below. You knew this wasn't a long-term, risk-adjusted return for a property investment, certainly not for a commercial office building that has cyclical factors in its cashflow. I guess what everybody was surprised by was something else — not that the market was heading for repricing but that debt finance basically froze to zero. With hindsight, I saw a few transactions in New York City in 2007 where the largest bidders against each other were some of the German Landesbanken. When the German Landesbanken start to play a major role in New York City or Manhattan property financing, that is probably a sign that you should take your money and run. I'll wait for the likes of J.P. Morgan to expand market share again, and that is probably a good sign that things have turned.

2008 and 2009 were bad, and 2010 is expected to be no better despite signs of an uplift in some markets. What do you think will be the catalyst for a return to better times?

We first have to unwind the sins of the past. That hasn't happened yet,

a lot of people are clinching on to their deals, postponing the day of reckoning because their debt has not matured yet. Encouraged, in some respects, by the banks that have not taken enough write-off on those debt packages to allow for a resolution of the problem.

Can the banks' "extend and pretend" exercise continue for much longer?

They are trying to buy time. They have so many write-downs and are trying to stagger them out over time. It cannot continue indefinitely because they are preventing good future business from happening because they have no money. On the one hand, you want to stretch it out to spread the pain over time; on the other hand, you miss growth opportunities by doing so.

Different organisations will choose differing timelines to find that middle ground, but many banks are doing this extend and pretend at the moment, and that's why we're seeing so few transactions happening around distressed sellers. But they do have to happen because of the point I made earlier: with a building, you don't have as many levers to push to create free cashflow as in a company. You can say with a much higher degree of certainty who is not going to make it. There's not going to be some miraculous cashflow increase that allows the banks to service the refinancing of their packages.

Banks should recover from other problems in the course of the year, and my prediction would be that we'll see an increase in transactions, an increase in this unwinding, starting this year going into 2011 and 2012. This has to happen before we see better times because the market has to reprice. We still have not had the repricing in commercial property that one would expect. US-REITs corrected more than 40 percent during the period from 2007 to 2009, while the NCREIF Property Index corrected only by about 10 percent over the same period. The markets have to reprice, and growth has to resume. So the question is: when will the economy get back to a normal growth pattern? ❖