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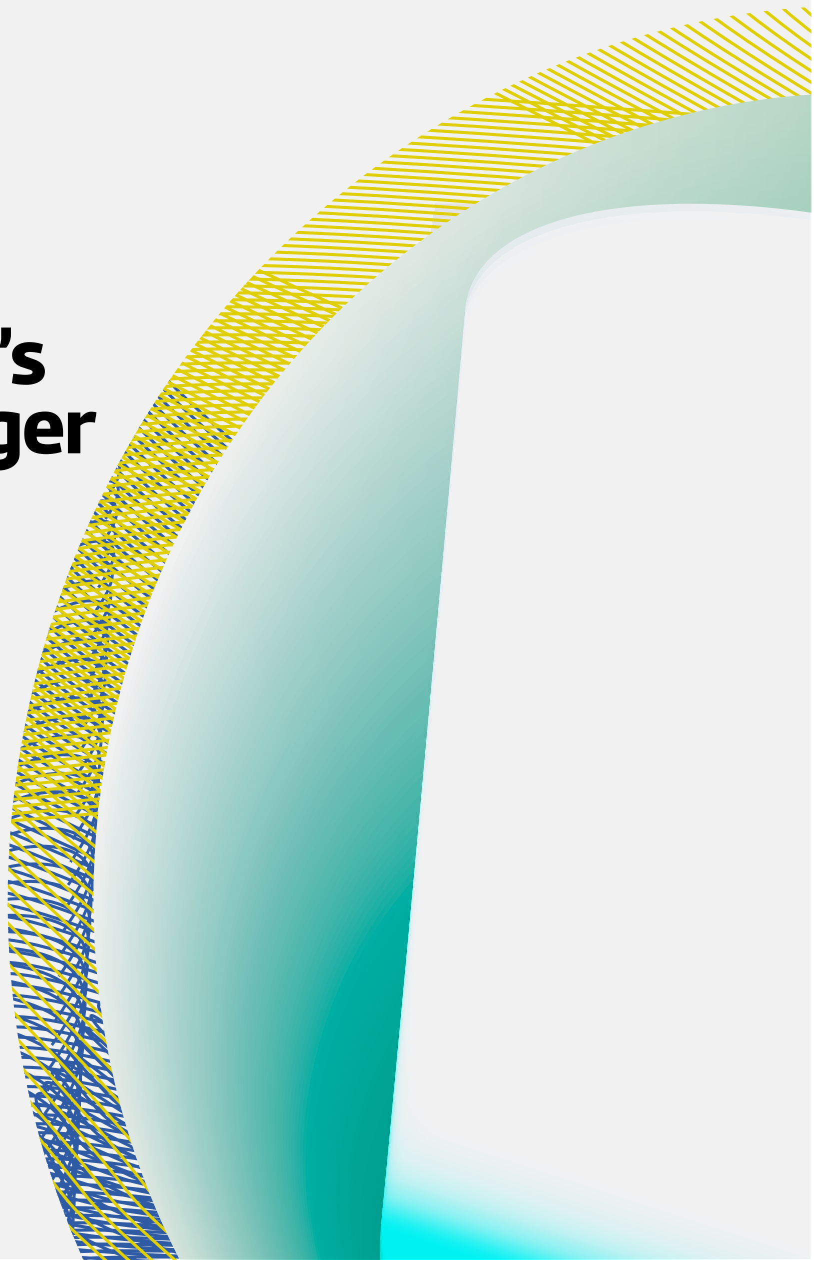
In-depth Analysis From PrivcapRE.com
Q2 2014

The Investor Issue

Inside Texas ERS's Emerging Manager Program / 15



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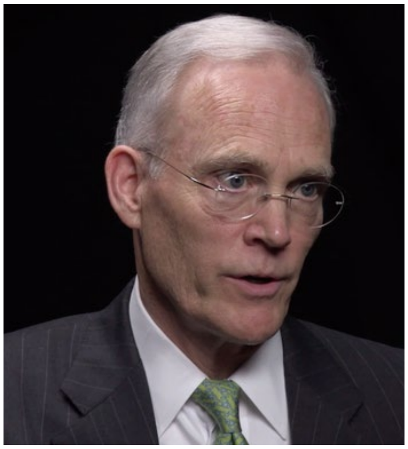

Jerry Gates, Hamilton Lane

This special report includes the following new video programs. Watch them at PrivcapRE.com

RE Watches for Inflationary "Velocity of Money"
Jerry Gates of Hamilton Lane provides an outlook on the global RE market. Baby boomers are expected to cut spending, and there are conditions to look out for that could lead to a bubble.

Pockets of Opportunity, But Focus on Net Returns
Real estate investors need to keep expectations for returns in check in the current market and not use outdated benchmarks, says Jerry Gates of Hamilton Lane.

The Evolution of Term Sheet Negotiations
LPs gained power in the wake of the financial crisis when capital commitments were scarce. But some balance has returned to the market, says Josh Sternoff of Paul Hastings.

Survey Says: Global Institutional Investors Upping RE Allocation
PREA's Greg MacKinnon shares findings from a global survey of RE institutional investor intentions. Investors outside the U.S. are most likely to increase allocations to the sector.

The Changing Multi-Manager
Jeremy Plummer of CBRE Global Multi Managers and Steve Coyle of Bentall Kennedy share their views on the fund-of-funds industry, its challenges, and its future.

Avoiding a Beta Play in RE Asset Allocation
NEPC's Sean Ruhmann argues that slicing and dicing a real estate asset-allocation model too far into markets and property types risks creating a beta play in portfolios.

COMING SOON on PrivcapRE

Deal Story: Phillips Edison's Kenwood Collection
Jeff Edison of Phillips Edison talks about transforming a stalled 16-story, partially completed development into a leading retail center with Saks as anchor tenant.

U.S. CRE Market Faces Uneven Recovery
Robert Lieber of C-III Capital gives a macro look at the real estate market, including the impact of Fed moves, where rates are going, and what areas are bouncing back.

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Must-see thought leadership from **PrivcapRE.com**

Harrison Street's Evolution

Christopher Merrill of Harrison Street Real Estate Capital tells PrivcapRE about the group's strategy, where he sees opportunities, and how they built the company to run an open-ended core fund.

Deutsche Asset Eyes Regional Opportunistic Fund Investors

Todd Henderson of Deutsche Asset & Wealth Management (formerly RREEF) talks about the firm's $12B of capital inflows in 2013, the continued focus on core, and how the firm has continued its opportunistic investing.

A Hospitality Comeback

The hospitality business—particularly limited-service hotels—has bounced back from recent lows, says Tyler Morse of MCR Development.

CRE Debt in Equilibrium as World Eyes U.S. Opportunity

Drew Fung of Clarion Partners tells PrivcapRE why U.S. real estate is on the world's radar, predicts how interest rates will look in 12 months, and explains the demand for floating-rate mezzanine loans.

Brazil's Real Estate Evolution

Jim Worms of Paladin Realty delves into changes in Brazil's real estate market in the past 15 years, financing, the state of the housing market, and the challenges of building affordable housing.

U.S. Debt Markets: Overfunded and Mispriced

Former CBRE Capital Partners president Ethan Penner talks about finding relative value in debt, how the European debt markets offer better opportunities than the U.S., and how broader mandates are critical to success as a PE real estate GP.

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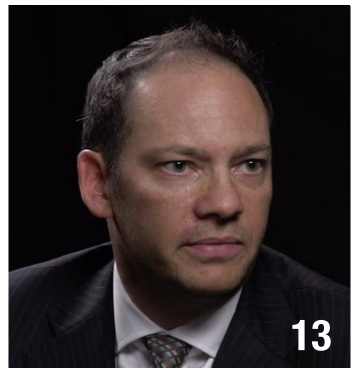

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Interviews in this report have been edited for length and clarity.

History, Discipline, and Shorter Real Estate Cycles

If real estate cycles are getting shorter, what does that mean for investors in closed-ended private equity real estate funds?

Market Analysis by Editor **Zoe Hughes**

Of all the lessons learned since 2008, there is one that LPs fervently hope GPs have taken to heart: that it is better to hand back capital than to invest when opportunities have gone beyond them.

It was something that few managers showed a talent for in the run-up to the financial crisis. Little more than six years on, with asset prices climbing and cap rates declining closer to, and sometimes below, pre-crisis levels, investors are starting to quietly wonder if history will repeat itself.

Such contemplation is being driven by the thought that real estate investment cycles could be getting shorter. PrivcapRE can't profess to back this with algebraic equations forecasting real estate's new phases. However, many investors, consultants, and managers are surprised at the speed and scale of the recovery in key parts of the global property market. And there is concern that prices are racing ahead of fundamentals.

Much of the attention has focused on the U.S., not least its gateway cities. The Moody's/RCA Commercial Property Price Indices, which track price changes based on repeat sales, show apartments and central-business-district office assets surpassing their 2007 peaks by as much as 11 percent. European managers are also worried that the sheer weight of capital in the region is driving pricing in certain markets, for some assets, well beyond the realms of rational rent growth assumptions.

"Investors can only hope that GPs have learned from history and now have the discipline to turn off the deal spigot when the markets become fully priced."

So do tighter cycles really matter? They do when set against the context of investing through a closed-ended private equity real estate fund, which has a typical seven-to-10-year life. As the cycle gets shorter, investment periods will increasingly span the life cycle of the market, the highs and the lows. And as one investor commented, if GPs are not reaching the level needed to get their carried interest, the industry is "either completely fooling [itself] as to what [it] expects to get or it's the [closed-ended fund] structure that's an issue."

One potential response to shorter cycles could be to reduce the investment period of a fund, and even the fund life. The option was raised by LPs in the immediate wake of the crisis as they sought greater control over investment strategy, and it has once again become moot. However, unless LPs want to see their manager constantly on the road trying to raise their next closed-ended vehicle, shorter investment periods and shorter fund lives could work against their best interests.

LPs should also be conscious of the impact shorter hold periods have on their own portfolios. A recent study by Joseph Pagliari and PREA showed that the drag effect of asset management, acquisition and dissolution fees, and various fund-level fees and costs on net levered returns fades the longer an investment is held. So while shorter investment periods and funds could mitigate deals from spanning the entire life cycle of new, tighter real estate cycles, it would do so at the expense of an investor's net returns.

There seems only one answer left: for GPs to hand back capital when markets move too far and too fast. Investors can only hope that GPs have learned from history and now have the discipline to turn off the deal spigot when the markets become fully priced. ■

Investors, Lower Your Expectations

The economy is making a comeback, but demographics and the possibility of a bubble make for a worrisome future, says **Jerry Gates** of **Hamilton Lane.** Meanwhile, investors looking for returns need to update their expectations.

Bio

Jerry Gates is the head of global research at Hamilton Lane. Previously, he was a managing director and head of global real estate investments at Morgan Stanley Smith Barney and a managing director at Citigroup.

Videos:

1. RE Watches for Inflationary "Velocity of Money"
2. Pockets of Opportunity, But Focus on Net Returns

PrivcapRE: You've joined us to help set the scene for investors who face some significant uncertainties. Real estate is closely tied to GDP growth, so let's start there. What's your outlook for GDP growth, and are you concerned about where growth is coming from in the future?

Jerry Gates, Hamilton Lane: I am worried about the long-term economic growth for the globe. Historically, much of the world's growth has been derived from the consuming regions of the world, particularly the U.S. and Europe. Both of those regions are in for a fair amount of slow economic growth due to low consumption levels. The world is so interconnected today that it has a domino effect.

What's your expectation for that recovery, globally and in the U.S.?

Gates: Maybe we could start with why we haven't experienced a more robust recovery. If we look back to the economy leading into the downturn, one of the big drivers was a significant increase in household debt, which as a percentage of disposable income reached a peak of 130 percent by 2007. After the downturn, people have been de-levering, and that figure dropped to 104 percent, still well above the 65 percent that was the earlier norm. I don't think we're going back to 65 percent, but we're still headed south.

Are you seeing signs of the savings rate changing?

Gates: I don't see any improvements in the near

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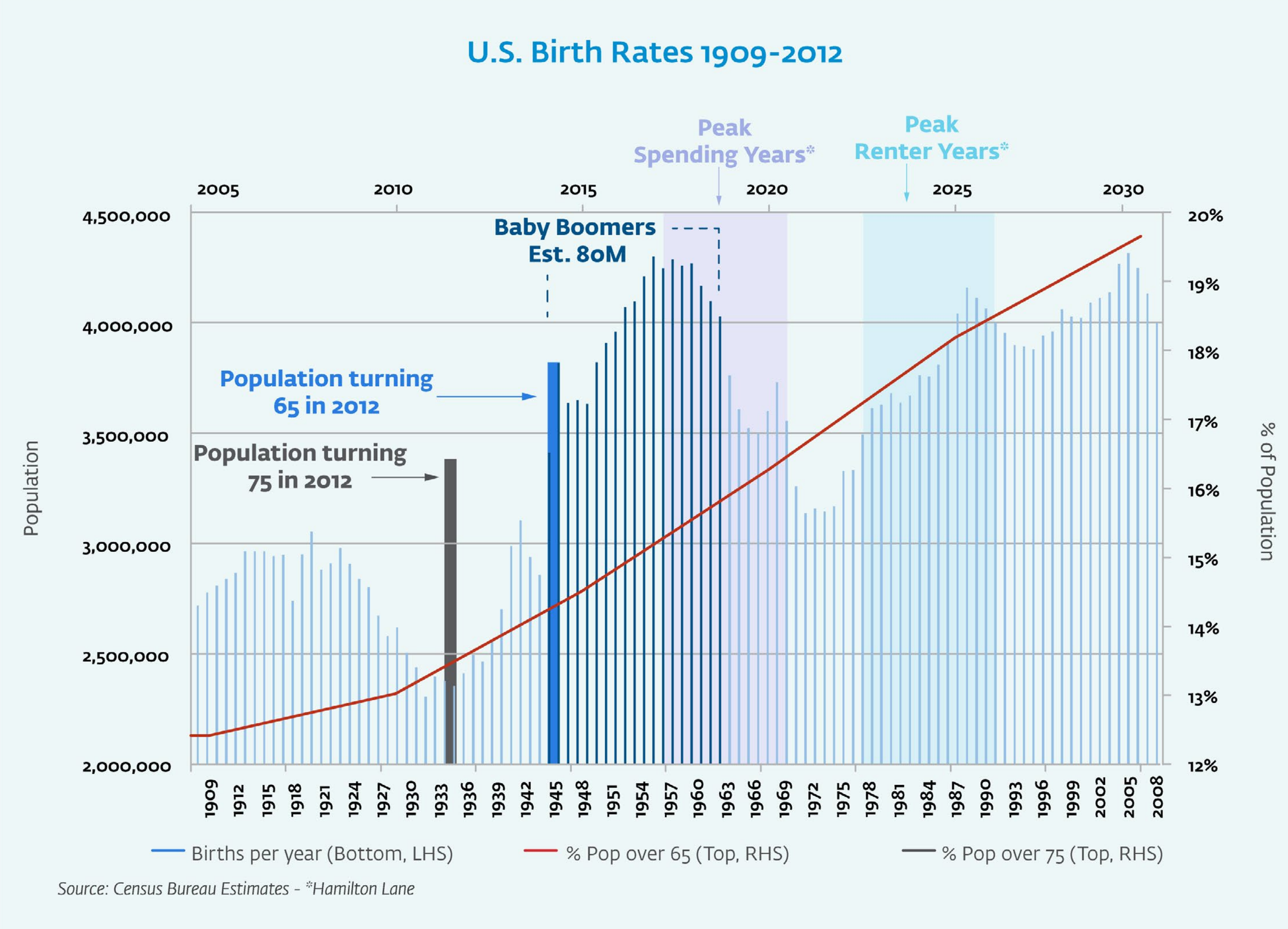
The Power of Demographics
With an aging population and changing spending habits, investors should place greater weight on demographically-driven investment strategies in the US.



term for de-levering and household median income, but one thing that we've looked at closely is demographics. I'll point out a couple of things on the birthrate chart [see above]. From roughly 1935 through 1960 there was a tremendous increase in the birthrate, and a big part of that was the baby boomers. Then we had a steep falloff, so the baby boomers are now in retirement or thinking about retirement, and they're marginally cutting their consumption every year. That's another factor that has me concerned going forward.

The echo boomers—the offspring of the baby boomers—unfortunately don't reach their peak spending years until the end of this decade. So we could have slow economic growth for a number of years.

Do investors place enough weight on demographics when they're looking at their asset allocation policies?

Gates: Frankly, I don't think there are many investors who think about demographics. It's all about getting the highest return, not strategically about where they'll get good risk-adjusted returns or what investment strategies will generate safe returns regardless of what the economy does.

Do we see that the bulk of investors are looking more for the income component, or for total return?

Gates: At the end of the day, we've found that investors are interested in internal rate of return, and it's tough to go to your board of directors to

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explain a negative IRR. So mitigating the J-curve, generating early cash flow, tends to be important.

We've seen capital really come into debt—particularly distressed. Are you surprised at the amount of capital that comes into those sectors and how pricing has almost recovered?

Gates: I'm not surprised at all, particularly given the low-yield environment that we're in. Investors have to put money to work, and they're searching for asset classes that generate income and/or yield. Real estate is certainly one of those asset classes. Investor expectations, however, are a little behind. They may be looking for returns that are really unreasonable in today's environment. Two years ago, they were plausible; today, not so much. Investors today need to be thinking about net returns in the low-to-mid teens. I don't think anyone should be thinking about net returns north of 15 percent for opportunistic investments.

Will demand coming through take a while to come back into the economy?

Gates: I believe so; it could come back with a vengeance. Meanwhile, we've seen a lot of volatility in emerging markets. Investors have been putting money into some of the emerging markets, creating bubbles there. Then the Fed says they'll start tapering. Then the hot money leaves those emerging economies, and that creates havoc with the central banks in those emerging markets.

How are you expecting inflation and interest rates to play out?

Gates: I'm not worried about inflation for the near future. There are a lot of people worried about the money that's been created by the Fed, but a lot of that cash sits on the balance sheet as excess reserves. So the velocity-of-money concept really hasn't come into play.

We might see a marginally small increase in interest rates, but it's not something you need to be worried about for the following reasons. First, you've got the low projected GDP. Second, there's high U6 unemployment, which is what the Fed is looking at. The other factor is the stalled housing recovery, and the Fed can't afford to see big increases in interest rates.

"We don't need to worry until the GDP starts to pick up, banks start to lend, and the velocity of money kicks in. That's when we need to worry about things like inflation and asset bubbles, because there is so much money in the system."

–Jerry Gates, Hamilton Lane

Are we at risk with the policies in place of creating asset bubbles, whether it's for real estate or other asset classes?

Gates: Absolutely. We don't need to worry until the GDP starts to pick up, banks start to lend, and the velocity of money kicks in. That's when we need to worry about things like inflation and asset bubbles, because there is so much money in the system. ■

By **Zoe Hughes**

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The Art and Science of Real Estate Asset Allocation

Setting an asset allocation policy is the most important task faced by institutional investors. But there is no one right way to do it and few tools at their disposal to help them. There are, however, some important questions to ask, which can guide investors through the process.

"The financial crisis brought asset allocation to the forefront of everyone's minds and made everyone think about what they could have done differently during a capital markets event and what warning systems they have in place for future events."
-Paige Mueller, RCLCO

In 2008, traditional allocation models were deemed a miserable failure, as the world watched asset values across the board collapse under the weight of the financial crisis.

If there is one positive from the crisis, it is that it brought a greater focus on risk identification within portfolios, correlations within asset classes, and diversification.

Today, that razor focus on asset allocation remains, especially for real estate. Yet in shaping asset allocation policies, there are few tools and models, and certainly no guaranteed formulas, available to those challenged with the task.

"The financial crisis brought asset allocation to the forefront of everyone's minds and made everyone think about what they could have done differently during a capital markets event and what warning systems they have in place for future events," says Paige Mueller, managing director of consultant RCLCO.

In thinking through their real estate portfolio and the risks within it, Mueller says investors can ask themselves a number of key questions that will help them better shape their asset allocation policies.

Top-Down Analysis. From a top-down perspective, there are five fundamental factors that often shape an investor's view on real estate opportunities, prior to any allocation analysis. The first is: what is the role of real estate, and what are the goals of an investor? That boils down to the expectations of real estate and the investor's liabilities and obligations. For some investors, that means a cash flow orientation, while others look to total returns. Also, depending on an investor's goals, real estate performance might be benchmarked to a variety of different factors, not least cross-asset class benchmarks as well as property type benchmarks.

An investor's goals therefore drive the second question: What are your limits? How much leverage fits the portfolio goals, and are there rules about housing real estate debt and equity? Are there prescribed ways to hold public and private real estate? Also, how far can a real estate allocation be decreased or increased? As Mueller says, "It's about understanding the volatility parameters at the outset."

And size matters. The size of an investor portfolio, and the staff within that real estate department, dictates the third question: Should I invest directly or indirectly, or follow a combination of the two? "Everyone wants to have control over their portfolio, but to have control over decisions, you need to have staff and time to do it," she says. The trend for control goes almost full circle back to the 1990s, when separate accounts were in fashion. "Investors then became concerned about diversification, and so the industry moved more towards the fund model," says Mueller. "The tension of having control, investing directly, and having diversification—there has to be a balance between them all." The tension is all the more apparent when large institutional investors are investing overseas.

The act of investing overseas itself raises the fourth important question for constructing real estate asset allocation policies: What's the right tax structure? Understanding your own tax structure in any given country, as well as those of your main competitors in that country, can dictate how investors play the real estate game, whether through debt, equity, or entity-level investments, as they seek to minimize the impact of tax and maximize cash flow and risk-adjusted returns.

It is the fifth question, though, that presents the greatest challenge to investors in constructing more efficient—and potentially better performing—asset

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Nine Questions Investors Need to Ask About Their Real Estate Asset Allocation

Top-Down Analysis	Bottom-Up Analysis
What's the role of real estate in the portfolio?	How quickly do you want to grow the portfolio?
What portfolio limitations do you have?	How do you get there?
What's your portfolio size?	What does the existing portfolio look like?
What's the right tax structure?	Setting a transition plan: What's realistic?
Vintage year diversification: Are you balanced?	

"If you think about the two ways to generate excess return in a real estate portfolio, it's about picking the right place to invest at the right time and then finding the right manager to do it with. When you have fine allocations to office or apartment or whatever, you're taking [one of those] off the table."

-Sean Ruhmann, NEPC

allocation strategies: How do we address vintage year diversification? "Real estate is cyclical," says Mueller, "and it pays to think about the impact of vintage and to structure your portfolio accordingly." Few investors can run their real estate allocation down to zero, and for investors invested solely in closed-end funds the ability to liquidate in a timely fashion is extremely restricted. Mueller says it's therefore wise to pay close attention to the supply-demand dynamics of real estate markets, the duration of leases within investor portfolios, and leverage on underlying assets. For instance, what's the exit strategy, and does the leverage match the hold period, or will you need to refinance in three or five years when rates and liquidity might not be as favorable? Are they variable-rate loans? "You think a lot about cycles in real estate," Mueller says. "What are you paying for those assets versus the replacement cost, and how much of your return is income or growth? To maximize risk-adjusted returns, you need to be able to reduce vintages in times where the forward risks are not justified and structure the portfolio to provide liquidity when needed."

Bottom-Up Analysis. So what about the real estate? After the top-down parameters are in place, Mueller says investors should think more in-depth about allocation models. "While there is no magic formula, investors can approach the task from a number of other angles, some top-down and some bottom-up," Mueller says, citing a mix of historic performance and correlation analysis, risk budgeting, economic factor analysis, liquidity, and cash flow analyses, among many others.

This is where investors and consultants take a detailed look at the opportunities and current market conditions and the existing portfolio and ask the question: How can a plan sponsor realistically achieve its goals over one, two, five, or 10 years? As Mueller says, "I want to understand how much the portfolio needs to grow, and how much of the existing portfolio is coming due, to create a transition plan for the overall portfolio that can realistically be implemented." And this is where the science of asset allocation morphs increasingly into art. "Everyone would love to say there's a perfect answer to asset allocations, but there isn't," adds Mueller.

In setting asset allocation policies, though, it's also important to factor in the need for some flexibility to respond to market conditions. Craft a real estate policy too narrowly, by specific property types, markets, and submarkets, and, as Sean Ruhmann, principal, private markets, at consultant NEPC says, asset allocations run the risk of becoming a beta play.

"If you think about the two ways to generate excess return in a real estate portfolio, it's about picking the right place to invest at the right time and then finding the right manager to do it with," he says. "When you have fine allocations to office or apartment or whatever, you're taking [one of those] off the table." However, providing flexibility adds risk to a portfolio: "We think that level of risk is worthwhile. Otherwise, you're just becoming closer and closer to a pure beta play, which I don't think a lot of our clients want."

Ruhmann also argues the same need for flexibility when it comes to recommitting to fund managers. "In a perfect world, you would continually re-up with the same managers who generate consistent performance," he says. "But I think you have to look at a manager every time they come around with a fund that they're raising and make sure that the dynamics that looked attractive the first time around still exist—and those things do change over time." Investors should therefore not be afraid of changing their GP relationships.

In the end, the key to successful asset allocations is structure and flexibility. Following the financial crisis, investors need and want better frameworks for shaping their real estate portfolios, to be prepared for a capital markets event but also to help portfolios perform more efficiently across the cycles. In dealing with cycles, though, allowing room to maneuver is vital. As Mueller says, "Real estate is all about the cycle." ■

Click to watch this video at privcapre.com

Investors Hungry for More RE

For the first time, **PREA** has teamed up with European and Asian industry groups INREV and ANREV for a global survey on investor intentions. **PREA's Greg MacKinnon** says it shows allocations to real estate are set to rise.

Bio

Greg MacKinnon is director of research at the Pension Real Estate Association (PREA). Previously he was a professor of finance at Saint Mary's University in Canada and held other academic and research positions. He received his Ph.D. from the University of Alberta and is a Chartered Financial Analyst charter holder.

"Over 90 percent of investment managers said investors would deploy capital to Asia; only 50 percent of investors said they are. Sometimes what investors think and what managers think they're thinking are split in two." *–Greg MacKinnon, PREA*

PrivcapRE: A lot of attention is given to institutional investor allocations to real estate, with expectations that we're going to see significant amounts of capital come into the asset class. Give me the headline figures in terms of rising allocations, and what you expect for real estate.

MacKinnon: Globally, according to the survey, in the next two years 46 percent of the investors that responded expect to increase their allocation to real estate, another 46 percent expect to stay the same, and only 8 percent expect to decrease. So the story of more capital coming into the asset classes is good news.

Can you quantify the rising allocations in dollar figures?

MacKinnon: I can, but I have to put all kinds of caveats in front of it, because it's only based on the investors that responded to this survey. Asking those investors how much they plan to allocate in the next year, it's $47B.

Is it surprising that 7.9 percent of investors expected their allocation to real estate to decline, but for U.S. investors that number was much more—11 percent?

MacKinnon: It's not entirely surprising when you consider the maturity of the real estate programs of some of these investors. A lot of investors in Asia and the Middle East, and some in Europe, are new to the asset class, so they're just ramping up. In the U.S., a lot of investors have been involved in the class for many years. They're happy with the program, but they're not expanding. Some U.S. investors are looking to decrease their allocation, but others are looking to increase; it's a matter of what point in the investing life cycle they're in.

You mentioned Europe and Asia. Is that where we're going to see the greatest capital allocations for real estate?

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MacKinnon: Across the entire sample from all regions, current allocation is about 9.5 percent to real estate, with intentions to go to 10.3 percent by 2015. The biggest change is Asian investors who—not coincidentally—also have the lowest current allocation.

Does this mean that managers also have to be increasingly global when they're looking for capital to source funds, separate accounts, and JVs?

MacKinnon: There is a general shift in wealth from west to east, so that's where a lot of the capital is going to come from. If you want to be one of the global players in real estate investment management, then global capital raising is a must.

Then again, if you are a niche player serving your investors well, perhaps you don't have be global in terms of capital raising, because there's always going to be a cost-benefit analysis.

Raising global capital isn't only a matter of booking a plane ticket to Paris and getting off and collecting the check. You have to build the relationships. You have to be aware of various regulatory and cultural issues in both that country and the U.S. There's a cost to initiating a global fundraising program, and there's a benefit. Managers have to weigh those two things against each other.

Did you get a sense of geographies where European and Asian investors would like to invest their capital?

MacKinnon: Yes. We looked at three major regions—U.S., Europe, and Asia—as destinations of capital. More than 50 percent of investors said they plan to deploy capital into those three regions in 2014. The U.S., however, came out as the strongest destination amongst investors.

Over 90 percent of investment managers said investors would deploy capital to Asia, whereas only 50 percent of actual investors said they're going to deploy capital to Asia. Sometimes what investors are thinking and what managers think they're thinking are split in two.

Talk to me about inflation-hedging abilities. Managers rank that highly in terms of the role of real estate for investors. But when it came to investors, they didn't rank it as highly.

MacKinnon: If you look at the evidence on whether real estate provides an inflation hedge, it's all over the board. There are investors who buy the story that real estate is an inflation hedge, and hopefully they're creating a real estate portfolio that will do that for them. For other investors, that's not the role they're looking for with real estate in their portfolios; they're investing for other reasons. It's interesting that managers think investors are placing a lot more emphasis on income and inflation hedging than the investors actually are. ■

By **Ainslie Chandler**

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Catch-ups Carry On

GP remuneration, particularly catch-up provisions, came under fire from LPs in the wake of the financial crisis when investors gained the upper hand in negotiations. But the market has now adapted and stabilized, experts tell PrivcapRE.

Josh Sternoff, Paul Hastings

Real estate markets are notoriously cyclical. And with each stage of the cycle, a different part of the investment ecosystem gets the upper hand.

In the years immediately following the financial crisis, LPs were left in a position of power when it came time to negotiate with fund managers. Amid the uncertainty, many investors refrained from investing or shed their existing investments. So those still in the market, looking to invest, held capital that managers desperately wanted.

With conditions firmly in their favor, savvy LPs took the opportunity to rebalance investment term sheets. "If we were having this discussion in mid-2010, any fundraising, no matter who the partner might have been, would have been very difficult, and people would have been hearing terms from the LPs that they might not recognize in their experience with their prior funds," Mercury Capital Advisors managing director Alan Pardee says.

Catch-ups, the speed at which GPs are paid after the stated preferred return is hit, was an area of particular interest, says Josh Sternoff, partner at Paul Hastings.

"Immediately after the economic crisis, in general there was a feeling by limited partners that fund terms in the previous period had gotten too GP-friendly, and that related not only to economics but governance and a whole host of issues," Sternoff says.

Many LPs wanted to scrap catch-ups altogether, or at least to alter their structure. Prior to the crisis, it was not uncommon to have 100 percent catch-ups.

> **"Immediately after the economic crisis, in general there was a feeling by limited partners that fund terms in the previous period had gotten too GP-friendly."**
>
> *–Josh Sternoff, Paul Hastings*

LPs were successful in tipping the balance in their favor, if not doing away with catch-ups altogether, with splits of 60-40 and 50-50 emerging from hard-fought negotiations.

While some of the pressure on GPs has lifted in the years since (on issues including management fees, committed capital, and asset management charges), some elements of term sheet structure, including catch-up and some carry structures, have fundamentally changed.

Pardee now sees three basic models of term sheets for value-add and opportunistic funds, com-

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"If we were having this discussion in mid-2010, any fundraising, no matter who the partner might have been, would have been very difficult, and people would have been hearing terms from the LPs that they might not recognize in their experience with their prior funds."

–Alan Pardee, Mercury Capital Advisors

pared to one standard model in the pre-crisis period.

"Some [GPs] are getting a 10 percent return, a catch-up of some speed, and a 20 percent carry. Some might end up having no catch-up at all. It instead becomes a hard hurdle of 10 percent. Then the rest is split 80-20, so the GP has just forgone that first 10 percent. That's one model," he says.

Some funds have altered the distribution structure so the preferred return is as low as 7 or 8 percent, with a pure 80-20 split thereafter, eliminating the catch-up, according to Manjul Ramchandani, managing director of Greenhill & Co.'s real estate capital advisory business.

Another new model includes a multi-tiered preferred return and carried interest process in which the GP may get one percentage of the profits up to a certain point, then a higher level once a second target is reached.

"It's inserting another break point, which could have people earning lesser amounts of carry on the same outcome," Pardee says.

Ramchandani says the issue of GP remuneration in general has also been brought to the forefront.

"During and after the crisis, a number of investors have pushed back on the catch-up structure, which actually means saying they want a better alignment of interest—saying, 'Yes, sure, we are happy to share the 20 percent of profits that you typically get, but we want you to get it at a much later stage: either when you have achieved your targeted rate of return, or at least when you are closer to that than you would be in a catch-up,'" he says.

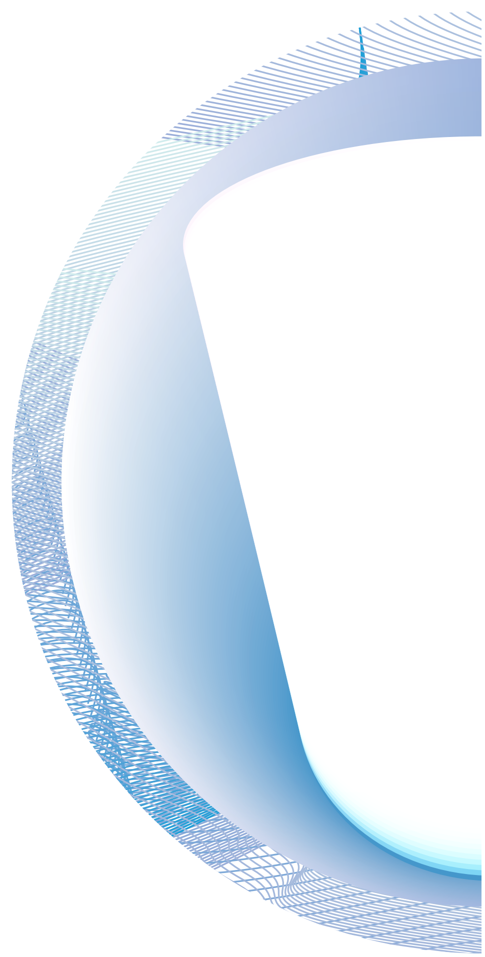
"It might not be a situation that the investor is not happy with the manager. It may be the investor feels it may align the parties' interests at a better level."

However, Ramchandani says fund managers have not been affected equally. Managers who have underperformed are more likely to have to incentivize their LPs, negotiate a different hurdle structure, or give up some of their catch-up.

"In short, all things are driven by supply and demand in this market," Pardee says. "So those GPs who are sought after might have a term sheet that looks akin to what they looked like in, say, 2000. Those in the middle of the pack will experience what the GP-LP dialogues have created today. And those that have had some challenges might find themselves breaking some ground that might creep into the rest of the market over time."

After the upheaval of the past few years, Pardee does not expect much more change in the short term.

"I would be surprised to find that a term sheet in 2015 would look radically different than a term sheet in 2014, even though a term sheet in 2014 looks radically different than a term sheet did in 2009," Pardee says. "Term sheets evolve, but they don't evolve overnight. They usually evolve after some kind of market calamity." ■



By **Zoe Hughes**

ERS's Emerging Program

The Employees Retirement System of Texas plans to build its emerging manager program to $1B by 2019

In less than four years, the Employees Retirement System of Texas (ERS) has become one of the most influential investors in the U.S.'s emerging manager space. By 2019, that influence will have grown significantly as the pension's emerging manager program doubles in size to almost $1B.

ERS's commitment to emerging managers across the asset classes isn't just in dollar terms. Ann Bishop, ERS Executive Director, tells PrivcapRE: "We are in this for the long term. We want to see people succeed, and we want to be there next year and the next year and the year after that."

Adds Bishop: "It's where a lot of the growth will come in the future. The returns are good, and there's a lot of satisfaction in watching someone grow. But at the end of the day, we're not going to do something that isn't good for the Employees Retirement System of Texas. It has to produce."

That sentiment is echoed by Bob Sessa, director of real estate at the $25.3B public pension fund, who calls for greater "enlightenment" of investors.

"Investors are already investing in emerging managers; they might not call it emerging managers, but they are doing it," he says. "There's a lot of alpha to be generated investing with smaller first-, second-, and third-time funds."

The challenge for some investors looking to real estate managers on their first, second, and third funds is quantifying performance above and beyond the cost of investing in the space.

The ERS program formally started in 2010 and has yet to see a full cycle of its investments, and therefore performance data, says Sessa. Investing a total of $90M with multi-managers Oak Street Real Estate Capital and Morgan Creek Capital Management, and $15M directly with real estate manager Pennybacker Capital, ERS targets first-, second-, and third-time real estate fund managers, usually raising less than $500M and with less than $1B in assets under management.

Inside the ERS Emerging Manager Program

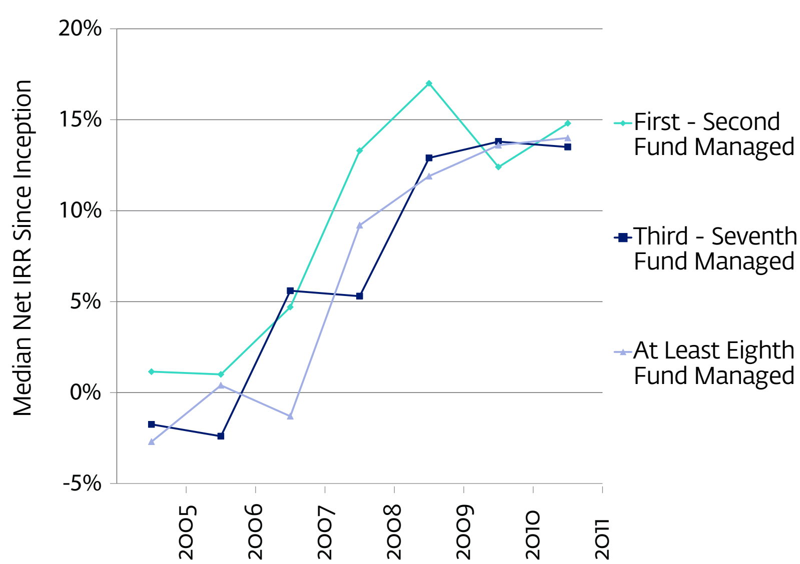
ERS eyes new RE emerging manager mandates in 2015 and 2018

Current allocation to emerging managers, all asset classes	$525M
Target allocation to emerging managers by 2019, all asset classes	$963M
Current allocation to real estate emerging managers	$105M
Target allocation to real estate emerging managers by 2019	$175M
New real estate emerging manager mandates, fund-of-funds format	2015 - $50M 2018 - $50M

*Data from Texas ERS board of trustee emerging manager tactical plan presentation, Feb. 25, 2014

Emerging Managers' Outperformance

Emerging GPs have outperformed established rivals since 2005



Source: Preqin April 2014 Manager Size and Experience Report

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"It's not just the alpha; investing in emerging managers complements and diversifies ERS's portfolio," says Sessa. And by investing in a fund-of-fund/multimanager format, Sessa says, the full benefits far outweigh the costs.

"Because of the larger check that ERS needs to write, we would not be able to commit capital to as many funds in the emerging manager space," Sessa says. "By investing through a fund-of-funds vehicle, it means that instead of committing to just one or two funds directly, we can do eight to 12 on a regular basis.

"Then there's the mentoring and the process post-commitment," Sessa adds. "We really don't have the expertise, resources, or time to do that."

While there are costs to investing in emerging managers, including additional investment staff, or those incurred through multimanagers or separate account mandates, hard data is starting to show the cost may be worth it, with emerging managers outperforming their more established peers.

An April 2014 Preqin study revealed that the median net IRRs of first-or second-time funds exceeded that of funds managed by more experienced managers for all but two of the 2005–2011 vintage years. The 2009 vintage year revealed the most dramatic outperformance, with first-or second-time fund managers posting 17 percent median net IRRs compared with 11.9 percent for managers that have raised eight or more funds. Smaller funds are also more likely to be ranked among the top quartile, as can be seen in Preqin's charts [see right].

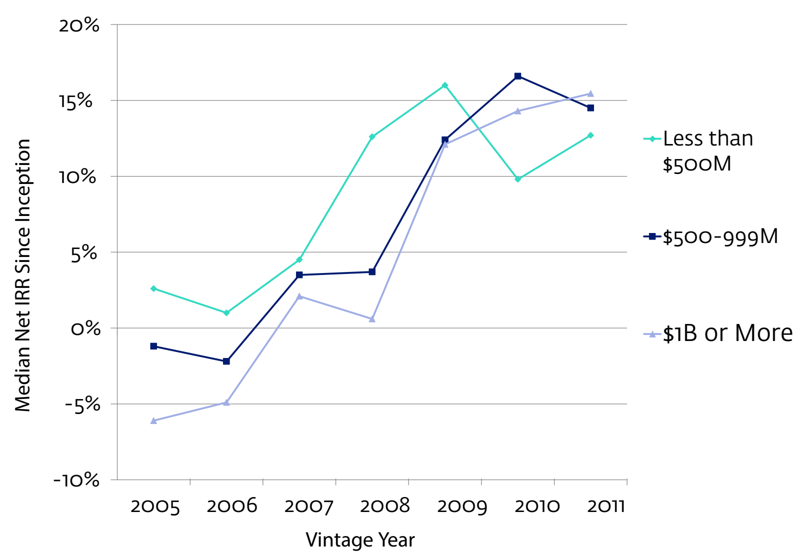
Performance is never guaranteed, however, and more recent data show a reversal of some of the outperformance, a reminder that institutional investors need to consider diversification benefits as well as returns.

"We invest in places that we wouldn't be able to invest in normally because of size, expertise, or diversification," Bishop says. "Emerging managers are a complementary investment strategy for us.

"It does cost money, and it does take time to make sure that emerging managers have a good future and add value to us. But it's not just about the returns. ERS is in this for the long term, and it's exciting for us. I had a small consulting business, so I personally understand what emerging managers are going through. I needed mentoring and help, and I couldn't have done that without someone wanting to take a chance. We want to give back." ■

Smaller Funds Start to Lose Ground

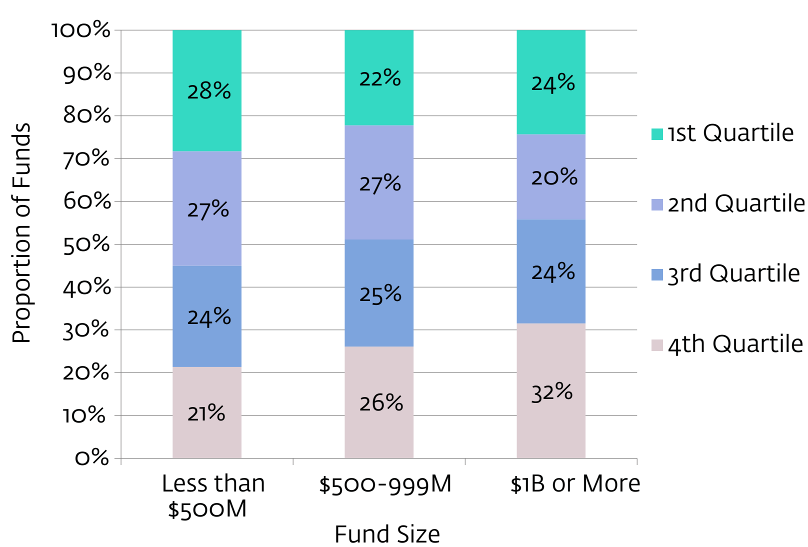
Smaller funds underperformed in the crisis, losing ground to larger vehicles



Source: Preqin April 2014 Manager Size and Experience Report

Smaller Funds More Likely to Be Top Quartile

More small funds are in the top quartile, and fewer in the bottom, than other sizes



Source: Preqin April 2014 Manager Size and Experience Report

LPs and Emerging Managers in the Portfolio

Experts from the UVIMCO, United Nations, and Texas Teacher pension funds talk about support for small and emerging real estate managers, and offer advice for the next generation of GPs

Stuart Bernstein

Senior investment manager, Teacher Retirement System of Texas (TRS) and head of the pension's emerging manager program

"This is a mission with a job attached. TRS will be a long-term participant in the [real estate] emerging manager space. It's under-developed, under-appreciated, and under-capitalized relative to similar private equity and hedge fund emerging manager spaces. [Emerging managers] are the greatest opportunity in [the real estate] space."

When it came to fundraising, though, changes were needed, Bernstein says. "There has to be a paradigm change in the way funds are raised. Fundraises are taking too long and that's too long as a first-time manager to have no capital inflow. It's a problem, and on top of that, we ask for emerging managers to look as big as you can."

"As an investor, I should want you to buy, manage, and sell assets. There has to be change."

Eric Lang

Managing director of real assets, Teacher Retirement System of Texas

"You want to make a good investment and find that next great firm and manager. Hopefully we are finding a successful firm with staying power, like a Blackstone or a Starwood. It's important for us to evaluate every manager on their merits, but we do need someone with a verifiable track record." ■

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Jason Love

Director, University of Virginia Investment Management Company (UVIMCO)

"What some institutional investors call small, we call normal. We have a strong conviction in investing in the lower end of the middle market and emerging managers. We feel there is better performance, and research supports the fact that smaller funds tend to perform better than larger funds.

"The biggest challenge [for emerging managers] is do they have the team necessary to operate a business and to source good investments? Do they have the infrastructure system, the process, and compliance to run a good business?

"[UVIMCO has] an operational due diligence team that assesses these issues, and we will help managers institute best practices. We certainly never go into an investment where we felt the manager didn't have sufficient financial resources or needed more staff. We take a partnership approach."

Roberta Waxman-Lenz

Investment officer - real assets, United Nations Joint Staff Pension Fund (UNJSPF)

"Stick to your knitting. If investors see strategy drift during the investment period, whether it's a shift from primary to secondary markets or from one property type to another, there needs to be a really good explanation. Not sticking to your knitting for the term of an investment period would raise questions on commitment to your mandate and put into doubt whether an investor would invest again."

Waxman-Lenz adds that the UNJSPF does not specially target emerging managers but invests in the "best managers" for its portfolio.

*Interviews conducted during the Employees Retirement System of Texas Real Estate Emerging Manager conference held in Austin, January 2014, and co-hosted with Morgan Creek Capital and Oak Street Capital.

Click to watch this video at privcapre.com

Experts Weigh In

The outlook for multi-managers

Jeremy Plummer
CEO, CBRE Global Multi Manager

It's not rational that U.S. investors are not embracing [real estate fund-of-fund models], particularly as a solution for their global investment ambitions. I'm very hopeful that as a global agenda becomes a higher priority for U.S. investors, given that the U.S. market is more fully valued, more investors start to look overseas. [I hope] that more investors will start to embrace this type of solution and understand what good value it represents, as opposed to being fixated with the idea that it's an expensive solution. It's actually the opposite.

Steve Coyle
Senior Advisor, Bentall Kennedy

I'm a big believer in multi-managers; I think it should work. I think that there are many misperceptions about multi-managers out there. However, I think it's a challenged model. And in the U.S., it's a challenged model for a lot of reasons. One is the role that consultants play. [Also] multi-managers have changed over the years, and there isn't a perception, necessarily, that their focus has changed. I think also, to some degree, the real estate multi-manager focus got challenged because the private equity multi-managers generally underperformed.

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Solutions Financing in Automotive Retail

How a strategic partnership is helping auto dealerships monetize the value of their real estate assets

Last year, sale leaseback specialist W. P. Carey struck a deal with RML Automotive to acquire the real estate assets of eight U.S. automotive dealerships. It was the first of an expected series of similar deals in a space that both firms say represents a great opportunity.

For W. P. Carey, many automotive dealerships own great real estate and are great potential tenants. For RML, the deal represented an opportunity to unlock value and put capital to work in a better way. According to Frank McLarty, CEO of RML, the Arkansas-based company had been growing strongly through acquisitions, and by 2012 "We wanted to continue to grow, so we looked for the best return on our equity investment. We also looked at the return we get on our operational investments versus the real estate—there's a substantial difference between the two."

Out of a desire to unlock the value of its real estate, RML entered into a sale leaseback transaction with W. P. Carey.

Jason Fox, managing director at the firm, says W. P. Carey carefully considers two elements when weighing a sale leaseback deal: first, the criticality of the real estate to the tenant, and second, the property's underlying fundamental value. For many automotive dealerships, both of these boxes are checked.

Fox's team has found car dealerships, because they often sell new and used cars, are less impacted by economic cycles. Also, parts and services provide steady cash flow and cover 70 percent of fixed costs for the average dealership. W. P. Carey considers this element of stability attractive. "Few institutional investors are currently targeting this opportunity," says Fox.

According to McLarty, the sale-leaseback transactions bought out some other property owners, allowing RML to consolidate its landlord relationships into one lessor. "To have one institutional landlord whose interest is purely in being a long-term, triple-net lease landlord gives us the clarity and certainty we need to aggressively grow our business, whether it's by improving operations or acquisitions," says McLarty. "We can focus our attention and corporate resources on operating the business, not on complicated real estate negotiations."

In August, W. P. Carey completed a follow-on transaction with RML, acquiring a Toyota dealership in Texas for $15 million. The facility will be leased back to RML on a triple-net basis for 16 years.

According to Fox, W. P. Carey remains highly interested in automotive retail deals. "This industry meets many things we look for in a long-term net lease. Given the lack of institutional capital focused on only real estate in the automotive market, there are opportunities to find ways to invest money at good yields." ■

What is a triple net lease?

When the tenant is responsible for all costs related to the asset being leased, in addition to paying rent.

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