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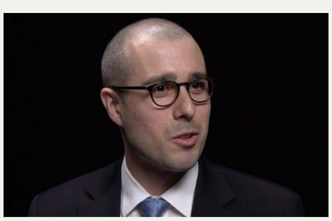
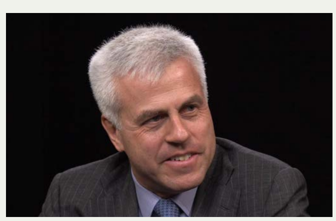
WEBINAR
Briefing

Inside Real Estate Co-investments

From the PrivcapRE webinar 'Co-investment: The Ultimate Portfolio Tool?'



Dillon Lorda
PCA



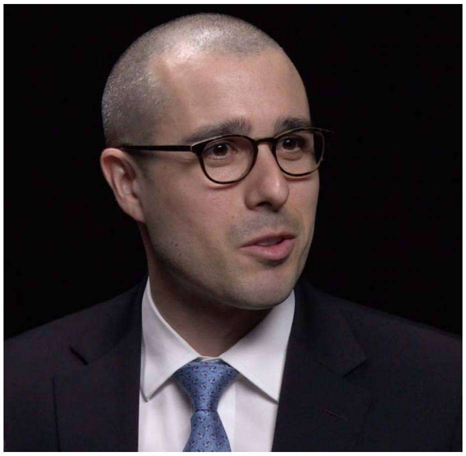
Tom Shapiro
GTIS Partners

Greg Spick
UPS Investments

Inside Real Estate Co-investments

Real estate co-investment strategies have become an increasingly vital portfolio construction tool for LPs. The Teachers' Retirement System of Texas recently highlighted co-investment as a top-five priority for its plan in 2015, but there are barriers to some LPs capitalizing on these types of deals.

The Panelists



Dillon Lorda
Principal,
PCA

Tom Shapiro
President and Founder,
GTIS Partners

Greg Spick
Senior Portfolio Manager, Real Assets,
UPS Investments

➜ BIO

Lorda joined PCA in 2008 and covers real estate and timberland. Previously he worked as a development associate for Del Mar Development in Mexico, responsible for all aspects of development, sourcing, structuring debt and equity, negotiating JV agreements, and overseeing construction, marketing, and sales. He has also worked at Time Equities Inc. and Bunge Global Markets.

➜ BIO

Shapiro is the president and founder of GTIS and its chief investment officer, overseeing all investment activities and strategies of the firm. Prior to starting GTIS, he was a senior managing director at Tishman Speyer, heading its global equity capital markets and dispositions group. He also ran GTS Properties, an acquisitions joint venture between Tishman Speyer and Goldman Sachs.

➜ BIO

Spick is the real assets portfolio manager for the UPS Group Trust. Prior to joining UPS, he held positions with New York Life and Credit Suisse and has transacted more than $3 billion of direct real estate investments during his career. He is a CFA Charterholder and holds an M.B.A. from the University of Georgia.

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Privcap: Greg, what role does co-investment play for UPS Investments?

Greg Spick, UPS: For UPS, [co-investing] and investing in pre-specified assets have become a meaningful way for us to invest capital into the real estate space. It's about finding investments that best suit the long-term objectives of our pitch and plan beneficiaries. We've done several hundred million dollars across several transactions—and moving forward, as we become more familiar with the space and more certain of our own capabilities as a team, I look forward to [co-investment] being an increasingly important part of our investment philosophy. In fact, it's something that we're looking to really expand across the entire private market space, whether it be private equity, credit strategies, etc.

Tom, share with us the reasons why you choose to offer co-investment opportunities to your LPs.

Tom Shapiro, GTIS: I'd say that there are really two reasons why. One is obvious, which is the deal is just too large and can't fit into the fund. But the second and maybe less obvious one is the returns. We look at everything on a risk-adjusted returns [basis], and we [may] like the opportunity from a risk-adjusted perspective, but the actual returns are lower than our fund criteria [allow]. In some cases [where returns are lower], we've actually given part of the carry from the co-investment back to the fund in order to have it create [for example] 13 percent or 14 percent IRR. But by giving the carry back to the fund, it can create a 20 percent return. That's good for all the fund investors, because they get a lower-risk fund…that still is creating very high opportunistic returns.

Let's discuss fees and the impact on investor portfolios. Are you looking for a significant discount in fees or carry?

Spick: Depending on the underlying strategy we're pursuing, the fees can vary pretty widely. However, there are really larger drivers that are much more important to us, rather than just the fee discussion. Really, we're looking for investments that best align with our long-term objectives. the carry back to the fund, it can create a 20 percent return. That's good for all the fund investors, because they get a lower-risk fund…that still is creating very high opportunistic returns.

> **"You need to understand fully the market [and] the drivers of the returns associated with [co-investment] assets. You have to have the resources both within the staff level…to understand those risks and underwrite them appropriately. "**
>
> –Dillon Lorda, PCA

Dillon Lorda, PCA: We're always looking for discounts on fees and carry, regardless of the topic of conversation. It seems like that's a very important driver of this investment strategy… coming from the board and investment committee level. One of the important caveats for us when we look at these opportunities—any opportunity, really—is [that while] fees are important, net returns really need to be the focus of any underwriting that we do.

In terms of performance, what are your expectations of co-investments?

Spick: Depending on the strategy, again, we will invest across the capital stack—everything from debt to levered equity. Everything is independently priced out, so to speak, relative to what the opportunity is and what public market comps are. For us, co-investments are substantially outperforming to date. The announcement from Texas Teachers [which is prioritizing co-investments] alluded to also [experiencing] substantial outperformance. The program here is still young, and a lot of programs across the country for investors are young, [but] there has been some outperformance.

Shapiro: If you start with low fees and…there's no J curve, [the investment] starts out even. Things being equal, that means that co-investments will outperform. We've found our larger deals have outperformed our smaller deals. So if you add that on, you're certainly going to see outperformance for co-investment.

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> "I look forward to [co-investment] being an increasingly important part of our investment philosophy."
>
> –Greg Spick, UPS Investments

How do you underwrite the risk of co-investments versus closed-end commingled vehicles?

Lorda: There are two levels to the analysis. You have to underwrite the assets, and you have to underwrite the manager who's going to be overseeing those assets. Whether or not you already have a relationship with the manager will facilitate the latter part of that analysis. But you need to fully understand the market [and] the drivers of the returns associated with that asset. You have to have the resources both at the staff level and, in our case, with your consultant to understand those risks and underwrite them appropriately, which isn't always necessarily the case.

How quickly do LPs need to say yes or no to a deal?

Lorda: It depends on the opportunity. Some have a very short fuse, and other times they end up being more complicated and drawn-out opportunities. In either case, they become an extraordinary drain on resources and necessitate that the team has the ability to clear their desk and be laser-focused on underwriting, both from the asset and the manager perspective.

Spick: We're usually indicating interest to pursue the co-investment within a week, sometimes sooner. And we're relying largely upon the GP due diligence to indicate that interest. Then, once that interest has been indicated, we'll start moving into asset due diligence, and that closing process can be 45 to 60 days.

Shapiro: It's really best to tell us early that this isn't going to work, so we can really focus on the LPs that are serious about taking the co-investment. If people want more information for fund purposes, that's great. But we're racing against the clock.

Tom, what type of investor typically takes on your co-investment deals?

Shapiro: I would say we spend significant time discussing co-investment allocations when investors make an investment in our funds. And then, of course, when it comes to the point where people have to make co-investments, it's always interesting to see who actually steps up. The sophistication, the ability to execute, getting buy-in from the organization is important. Most pension plans just don't have the staffing or the expertise in order to underwrite these. So it really varies.

How do alignment issues play out in terms of maintaining control, and how does that impact exit decisions?

Spick: It can vary. A lot of times it's aligned with the overall fund strategy, but that's one of the benefits of going into a co-investment, is you have some insight into what the exit is—and generally what the objectives are to get to that ultimate exit. [It's] extremely beneficial from that standpoint, whereas in a commingled fund, by the time everything gets invested, you vary in exit strategies, and it's a lot more difficult to ultimately forecast.

We're seeing a huge amount of money go back into the funds. Are you observing a decreasing need for GPs to offer co-investments?

Spick: For me, the opportunities are increasing. Certainly the announcement from Texas Teachers [indicates growing demand for co-investment deals], and it seems like many other large institutions have indicated interest and are pursuing various co-investment or more direct investment opportunities.

Lorda: I do [believe they will increase]. I don't necessarily think that it's going to be a great fit for our client base, but I imagine, with the way capital is being committed to funds, there are going to be a lot of smaller funds that find it challenging to raise capital through a closed-ended commingled fund structure in a timely manner for deals that they find attractive, and will have to go out to various parties on a one-off basis to raise money.

Shapiro: For sure, yes. We anticipate that we'll be doing a lot more co-investment, at least in 2015, than we did in 2013 and 2014.■