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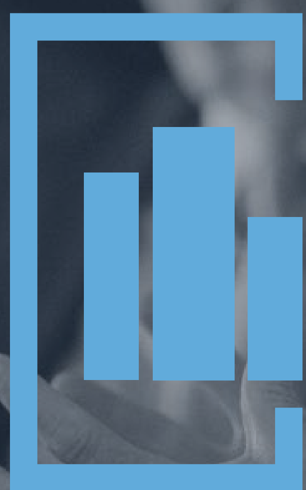

Real Estate Game Changers

A recap of Privcap's third annual real estate conference

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Sharp Views Amidst the Clouds

Privcap held its Game Change: Real Estate 2017 event on the 80th floor of Chicago's Mid-America Club, and while the view that day was mostly cloudy, the views expressed by our gathered experts had decidedly more focus.

Real estate investing involves the distillation of facts from many, many data inputs, including demographics, macroeconomics, regional trends, labor markets, technology adoption, asset management practices, and capital markets. The best long-term real estate investors have informed views on all of these overlapping influences (or at least, if they don't, they'd better act like they do).

The institutional real estate investors who gathered in Chicago are involved in the very serious business of putting capital to work for the long term. Many of them manage the retirement money of municipal employees, the endowment money of learning institutions, and the wealth of families up and down the HNW scale. Given the relative illiquidity of real estate, getting stuck in a property type or location just as a huge exogenous force hits can lead to lost value and dented reputations.

There was no discussion, therefore, about near-term trends—what are interest rates going to do next month, for example. What mattered more are the forces at play that might, for example, put malls out of business, make certain suburbs winners and others losers, and turn traditional core into a zero-return asset class. The trends that might lead to these outcomes will unfold over a decade, which is about the length of time that a private equity fund needs to chart.

The big questions for long-term real estate investing are in fact the big questions for society in general. How does the rising millennial generation want to live? Will they resist home ownership? Will they live in the same suburbs as their parents?

What will become of stores and malls once e-commerce surpasses traditional retail (it's still not even close)? How will the character of city streets and malls change? What activities will take place in spaces once devoted to the physical exchange of goods for money? If robots and driverless vehicles will sort and shop for us, where will this activity take place?

For every view on these and many other questions, there is a real estate play to be made, and the capital represented by the delegates to Game Change: Real Estate earmarked for real estate was truly impressive, both by way of amount and sophistication. We hope you enjoy a few of the highlights from the event in this report, and that you can attend our next gathering in 2018.

All the best,

David Snow
CEO & Co-founder, Privcap Media
@SnowsNotes

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The Millennial Impact on Real Estate

How America's largest generation is changing the property investment opportunity

Millennials are transforming the urban real estate market

Millennials are the largest generation the U.S. has ever seen. Numbering just over 83 million, they represent more than a quarter of the nation's population. And with their spending power, they're changing the way America does business.

They're having a significant impact on the real estate market. Unlike their parents, millennials enjoy life amid the hustle of urban hubs. They gravitate to downtown areas, where they tend to rent rather than buy. "Urban downtowns have revitalized in a number of gateway cities over the last decade," says Peter Ciganik, managing director at GTIS Partners. "Millennials have finished college and found their first jobs, and now they're able to set up their own households. Of course, those households will first be rentals. And these people are young. They enjoy the fun of the city."

For the past several years, millennials have flocked to the bright lights of "24-hour cities," and real estate investors have followed. Now, as rents in these places soar, millennials are migrating again—and investors are on their heels. For example, as San Francisco rents have ascended into nosebleed territory, priced-out millennials have shifted across the bay to Oakland and other "18-hour cities," with investors right behind, injecting capital into once-forlorn office, retail, and residential properties.

"In New York, we have a client that's investing in multifamily and residential in Queens right now," says Michael Schwartz, a principal at RSM US. "In the 18-hour cities, we're seeing an influx of people who don't want to live in the 24-hour cities because of price. They're moving to cities such as Columbus, Madison, Raleigh, and Nashville."

These next-tier cities are now the Goldilocks zone for investors: not too cold, not too hot. "Investors in search of yield need to go to these secondary cities, especially if you're a high-yield, high-return investor," says Andrew Jacobs, managing director at Metropolitan Real Estate. "San Franciscans and New Yorkers—young ones—are spending half their income or more on rent. They can't spend more. The wage inflation isn't there to support higher rents. So the peak, we absolutely see it."

As they age, millennials are influencing suburban real estate as well

Millennials are growing up, of course, and as they do they're getting married, having kids, and moving out of downtown areas, primarily in search of better schools for their children. "Unfortunately, downtown public schools in a lot of places have been underfunded for years," Ciganik says. "And how many people can buy a condo in New York and then send their kids to a private school? Not that many. So moving to a place where schools are good and space is affordable becomes the choice."

Still, a lot of these suburban-bound millennials can't afford to buy a house, so they rent. Result: Single-family rentals are now the fastest-growing sector of the rental market. Eight million new rental units have been filled over the last five or so years, and 5 million out of those 8 million are single-family rental homes, not high-rise apartments.

Fannie Mae has recognized this trend. In January, the agency announced it would guarantee the billion-dollar rental-homes debt fund of Blackstone, the largest owner of rental homes in the country. Not surprisingly, other institutional investors are getting interested in the rental-home sector.

"There are about 15 million rental homes out there, but most are still owned by moms and pops," Ciganik says. "Only about 280,000 of these homes are owned by institutions, less than 2 percent. But it's growing fast. It's actually growing faster than the multifamily REITs back in the early 1990s."

Millennial shopping habits are changing retail and logistics

Millennials prefer to do their buying online—they make over half their purchases there. But they do still enjoy some real-world retail experiences,

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and retailers are evolving to accommodate them.

"There has been a barbell in terms of success," Jacobs says. "There's an experiential nature to retail, especially on the luxury end, and people still like that. We continue to see growth there. On the other end of the spectrum are the discounters. In most cases, discounters are able to undercut online, so we'll continue to see demand for discounters. It's the in-between that's been really tough."

Malls that don't see as many shoppers as they used to are repositioning themselves to attract visitors with new offerings. They're adding restaurants, cafés, and bars, because millennials love to mingle. And they're adding medical offices, because "you still have to show up to your doctor's appointment—for now," Ciganik noted.

In many malls, onetime grocery stores have been taken over by health clubs like L.A. Fitness and XSport Fitness. "These malls were built at the intersection of Main and Main for so many years," Schwartz says. "There may be a higher and better use than an enclosed mall, but it's still great real estate."

Millennial work habits are reshaping the office landscape

Meanwhile, space for logistics has benefited from the boom in online shopping. "What's been bad for bricks-and-mortar retail has been good for logistics and industrial space," Jacobs says. "Both large distribution centers and, particularly, closer-in distribution buildings have seen extraordinary growth in rents."

Millennials like open-plan, fully digital, creative office spaces. This opens opportunity for some property investors but presents challenges for owners of old-school office buildings. "We have a building where Goldman Sachs and Facebook are tenants," Ciganik says. "What attracted them to the building is that it has high ceilings, it's all glass, so there is a lot of light, and it has redundant fiber. It's heavily connected."

With white-shoe firms as well as TAMI tenants (technology, advertising, media, and information) moving to the open-plan connected office, the downtown office landscape is shifting. "In New York, traditionally the highest office rents have been in the Plaza district, Park Avenue from 42nd Street up to 59th Street," Jacobs says. "Now we're seeing higher rents not only below 42nd but below 34th Street, in what we call Park Avenue South. I would say the buildings are physically inferior, but the rents are higher."

The first to move in were startups seeking affordability and raw spaces—"midblock, nasty buildings with loft spaces," Jacobs says. Now many companies that employ millennials are looking for similar office space. "I heard a midtown landlord say recently, 'We've got plenty of old crappy buildings in midtown,'" Ciganik added.

In Chicago, companies once wanted space with a view of Lake Michigan. Now they want to be near transportation. "Millennials want to be closer to the L, so the West Loop has really expanded," Schwartz says. "And you're also seeing a lot of residential development in the West Loop."

These trends are impacting traditional office hubs. As leases expire, tenants that no longer need so much space are downsizing. Who needs law libraries and conference rooms nowadays? In New York, tenants are leaving once-prestigious addresses to go downtown or to Hudson Yards. It all spells trouble for those 1960s and 1970s buildings in midtown that can't simply rearrange their interiors due to architectural limitations. Those formerly expensive buildings, with their deep cores and low ceilings, are emptying. "And for investors who have purchased those assets at 3 percent, 4 percent cap rates in a rising-rate environment, that will be challenging," Ciganik says.

Co-working office providers are becoming the biggest lessees

Co-working providers are now a force to be reckoned with. WeWork, the $17 billion startup, added hundreds of thousands of square feet worth of new Manhattan leases in 2016 and will soon be among Manhattan's top 10 tenants.

This has spurred investment in office properties that appeal to co-working providers. But there are risks in entering long-term leases with startups like WeWork. Does their credit hold up for the term or more when the investor wants to sell the building? "The jury is still out on the concept," Schwartz says. "To underwrite those properties now, a lot of our clients are taking a bit of a risk."

"We just signed on WeWork as a tenant, and we were hesitant to do it for more than a part of the building," says Ciganik. Although co-working providers have bolstered their reliability by branching out to sign deals with corporations that need overflow space, they are still particularly vulnerable to recession, because they rely on users who rent space on a daily basis.

"It's a convergence of asset classes: office and hotel," Ciganik says. "You would never think of them as having a common operating element. But you check into a hotel for a day to sleep, and you check into WeWork for a day to do your office work." ■

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Investing in a Radically Changing Industrial Landscape

Michael Brennan
Chairman, Managing Principal,
Brennan Investment Group LLC

With Michael Brennan of Brennan Investment Group

Privcap: Industrial real estate discussions often focus on e-commerce—Amazon distribution centers, last mile, those little brown packages landing on your doorstep. They're important issues, but when it comes to industrial, we're actually missing quite a big part of the equation, which is the manufacturing base. So, Mike, define what we mean when talking about industrial.

Michael Brennan, Brennan Investment Group LLC: There's about 30 billion square feet in the United States. A little over 60 percent of that is manufacturing. It's the largest industrial facility type in the supply chain, so it's really big. And it was only in 2010 that China surpassed the U.S. as having a larger manufacturing output.

Historically, it was tough to buy manufacturing, because the credo on the corporates was "Own your manufacturing building and lease your distribution building." Thus, it was pretty difficult to get a meaningful critical mass of an industrial.

You hear the headlines. Manufacturing is in decline in the U.S. The number of manufacturing jobs, the share of GDP—how can you consider manufacturing as a growth area for investment?

Brennan: For the story of U.S. manufacturing, we have to go through China. But if anyone's been in the business as long as I have, or been from Chicago, China is nothing more or less than the phenomenon of migration out of low-cost areas. That's been the case since the 1800s.

Growing up in Chicago, you'd see people leave. You'd see them go to Kentucky and Tennessee, where they had no unions. Then, when the unions came down there, the wages would rise, they would go to Mexico. And then when Mexico got too expensive, they all went over to Southeast Asia, especially China.

So China's pre-eminence in manufacturing is just the classical application of their comparative advantage of low cost. It's not logistical advantage. It's not technological advantage. It's low or no regulation, low labor costs, and so forth.

What's happening to China, and the story of the resurgence of American manufacturers, is based on a few things. The first one is that wages in China are rising.

The second thing is that a rising middle class in China means that the contract manufacturer has other options to sell his capacity to. Number three is probably underappreciated—it's that natural gas, which is an important cost for manufacturers, is one-third cheaper here than it is in Asia. Another thing—sort of the new manufacturing theme—is that we're going from mass production to mass customization.

So we want things faster, we want them the way we like them, and by God, it takes a long time to get things over to China. If you've ever seen the port delays and so forth, you know that if there was something we could do to get our stuff manufactured in the U.S., that would be better.

The last is robotics and automation, which is huge today. *The Economist* magazine has probably written 20 issues about robotics and automation, and 15 have been their cover story.

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Are you saying, then, that the rise of robotics and automation is actually bringing back the U.S. manufacturing base?

Brennan: Right. The rise of American manufacturing has to do with the relative erosion of the comparative advantage and low cost that China has. Now, there's a capital cost to that, but having robots and automation do those things is one of five things that have eroded the comparative advantage of China.

How does that actually increase the demand for the real estate? Are firms still scaling back in terms of how much space they actually need? Where is the growth actually coming from?

Brennan: About 350 American manufacturing companies have re-shored back on American soil, largely because the cost differentiation between the U.S. and China was gone. If business was better and they needed to make $200 million in plant and equipment, they would think twice about putting it in China. So positive absorption in the industrial space has been about 30 percent higher than it has been on the distribution space.

You talked about customization. One of the things that I thought was very interesting is the need for speed. This is not just businesses to consumers, but also business to business. Does that have an impact on industrial? Do you actually need space to keep your inventory for your customers? Is that having an impact in terms of your clients and your portfolio?

Brennan: Yes, it is. The inventory to sales levels are more elevated because they want their stocks to be replenished, whether it's business to business or consumer. So I think that that's true.

It's a political thing, too. The implications of the need for speed, and the labor that's required for [technologically advanced manufacturing], is that it will make us more urbanized. We had a lot of manufacturing in the U.S. being driven out into the peripheries because of lower cost. Now, if you need technological workers and you need to be closer to the consumption zone, you'll push it back in again.

I do want to touch on logistics, because obviously that is still an important part. As we see online retail really growing, do you envision more large regional distribution centers? Are we going to see more last mile? What type of industrial assets on the logistics side do you see?

Brennan: The e-commerce fulfillment buildings are different from cross-dock palletized shipment, because you've got big stuff coming in on one side, and then you've got parcel shipping on the other. That'd be your classic e-fulfillment building. The stock we have today needs to be modified or built differently. Then, if you see Amazon, they have a lot more people working there, so they need more parking and they need a lot more land. That's one thing.

The other thing is that most good logistics warehouse managers can make an e-fulfillment business out of a front-loaded or cross-dock industrial building. It's not perfect, but they can get by. The problem is, one of the reasons we haven't seen anything yet is that the logistical infrastructure required to do e-fulfillment is more significant than we would imagine. It takes reverse logistics. It takes a whole coordination of less-than-truckload, full-truckload, partial-shipment mechanized equipment inside, and people that know how to own and operate it.

Remember that the palletized distribution business is almost all outsourced, and that's not that complicated. If they're going to outsource that, they're sure as hell going to outsource e-fulfillment, right? Just what Walmart is doing now. But there's just not that many people in that business yet, and it's more complicated than you would think to get in there. So the requisite infrastructure to be able to handle all the retail demand for e-commerce isn't in place yet. That's a prerequisite in order to see e-commerce soar.

We built Amazon's first e-fulfillment warehouse in McDonough, Georgia, in 1999. They were pretty sure that they had it down, so they took 800,000 square feet from us. I took my board of directors then and I said, "Gentlemen, you're about to see the building of the future. Come take a look at what we've got." We opened the door, and stuff was flying all over the place. They had this new piece of equipment and the CDs and books at the time. They didn't know how to work the equipment. People were walking out with stuff.

I mean, OK, it's 1999. It's not 2017. But Amazon had been at it 15 years. They were ready for this. They had specialists, new special equipment from Germany. If *they* didn't know how to do it, how the hell do you think that it's going to be easy for every other retailer to be able to handle that? ■

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Keynote

Walton Street's Neil Bluhm

Lessons Learned and What's Ahead

Real estate legend Neil Bluhm discusses his start in real estate, what's changed, and where the risks lie in 2018

Neil Bluhm
Founder, Managing Principal,
Walton Street Capital

Privcap: How did you get into real estate? How did this all begin?

Neil Bluhm, Walton Street Capital: I was a young partner at Mayer Brown, but I always wanted to go into business. I left and joined my roommate from college, who had started JNB about three or six months before, and we started from scratch. We had three people and no business—and, with some luck, things turned out okay.

When you look back, what do you miss most about the early days?

Bluhm: There wasn't a lot of competition compared to today, there wasn't a massive amount of institutional capital, and in some sense, it was easier to go do deals. Some of the greatest deals we ever did—especially for our own account—we accomplished in those earlier days. Whereas today, if you wanted to do many of the things we did, you'd be competing with massive institutions with unlimited money: pension funds, sovereign wealth funds, etc. Then, a lot of things were done just based on relationships, and you weren't involved in a big auction like you are today. We bought Century City from Alcoa Aluminum—it wasn't an auction. We bought Urban Investment from Aetna. These are deals that we bought for our own account, because we're whole companies. It's very hard to do that today, although if you work hard and know people, and you're smart and you're lucky, you can do fine.

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What are some of the things that worry you in real estate today?

Bluhm: We can start with retail, of course. Retail is getting hammered right now, certainly in the public markets; it's a much tougher industry today. And it's probably not hit the bottom yet, because there's panic, really.

On the other hand, this is a business of location, location, location and of supply and demand, and none of that has changed. So there are a lot of types of shopping centers that are going to be obsolete. On the other hand, if you have really good locations, good properties, they'll do fine. The upper-scale shopping malls, the great ones, are still doing well, but they need to convert to more entertainment, more restaurants, and things of that nature. That's what we're doing with our property at 900 North Michigan, here in Chicago.

How much more do retail rents have to fall?

Bluhm: It's hard to say. But if you have an obsolete kind of mall and there's not enough demand, you're going to have a lot of vacancies at some point. That property may close. So ultimately, over time, there'll be less supply. But street retail, for example, is enormously popular in New York, Chicago, etc. Prices in New York went sky high for street retail in the luxury area. I mean really sky high. You saw your rents double. Now they've come down maybe 30 percent, but they're still very high. But people were renting because they just wanted to be in those locations with a flagship store.

I'm not kidding you when I tell you that retail is generally much tougher today than it's been because of the internet. Having said that, there are new stores that are actually doing well that are integrated into the internet. We have a store [in one of our properties] that specializes in men's clothing. You come in there and they measure you up. After that, you do everything on the internet, and it's doing very well.

Investors are searching for yield because there are not that many opportunities outside of real estate. Are investors stretching themselves to do deals to put the money to work? What are you concerned about?

Bluhm: What I've tried to do over almost 50 years is [not to] forget what happened last time. Learn a lesson. In 1990, we had a massive real estate crash. I started in 1970, so during that 20-year period, real estate was doing great. When the recession hit in 1990, that was the savings-and-loan crisis and everything. It was brutal—much worse, by the way, than 2008—for commercial real estate.

When you got around to 2005, '06, '07, '08, there really was not a lot of overbuilding in the commercial real estate business. The crisis in 2008 was caused by the single-family home mortgage crisis. So the second thing you learned was, just because [commercial] real estate is in decent shape and it's not oversupplied...you've got to pay attention to the other factors that could create a massive recession, because that's going to hurt even if you didn't have overbuilding.

But through all of this, the one thing you definitely learned was that if you own really good real estate (a), and (b) it's not overlevered, you get through these cycles and you end up making a lot of money, OK? And that's certainly what we've learned when we've developed and owned really good real estate, which is part of our long-term holding for J&B or my family office.

What are the specific risks today as it relates to cap rates?

Bluhm: I've lost a lot of money betting that interest rates were going up over the last several years, and they haven't. But of course, at some point that's going to change. And it appears like we will slowly start raising interest rates, so maybe in a few years, cap rates could go up a little. But I would say this to you: Cap rates are supply and demand of capital looking to invest in real estate, and there's massive amounts of liquidity in the world today, and massive amounts of capital that wants to buy real estate.

I don't see a massive correction in cap rates in the near term. On the other hand, everybody's nervous. ■

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The Day in Photos

Images from Privcap's
third annual real estate conference

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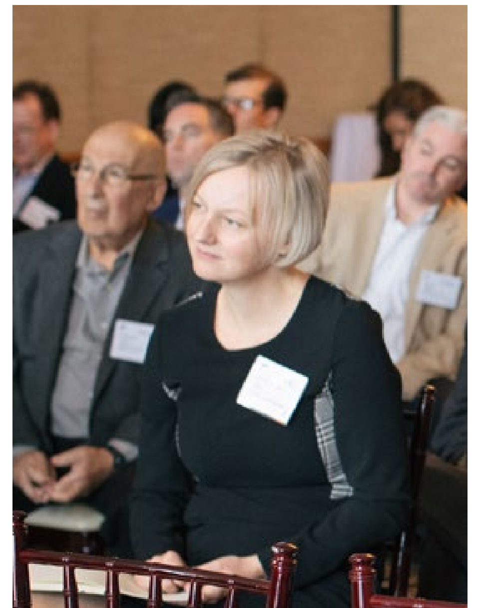

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Opening Panel Discussion

The New "18-Hour City"

Jason Kern
CEO - Americas,
LaSalle Investment Management

Dara Friedman
Senior Vice President, Portfolio Management,
Bentall Kennedy (U.S.) LP

Peter Ciganik
Managing Director,
GTIS Partners

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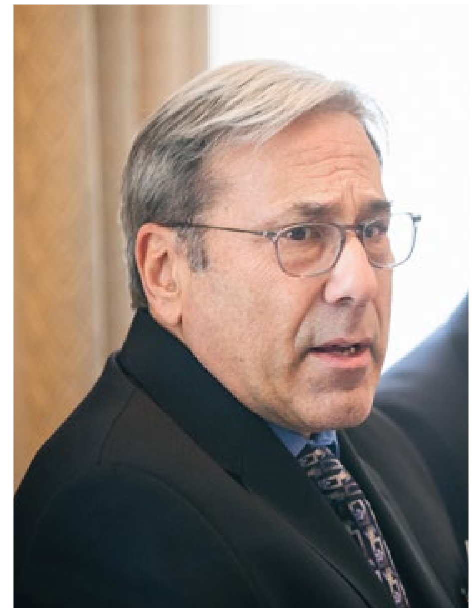
Morning Breakout Session

Regulatory & Tax Outlook

Ahmed Abdul-Jaleel
Assistant Regional Director,
U.S. Securities and Exchange Commission

Doug Cornelius
Chief Compliance Officer,
Beacon Capital Partners LLC



Don Susswein
Principal, Washington National Tax,
RSM US LLP

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Morning Breakout Session

Deal Structure Dynamics

Neil Furmanski
Partner,
RSM US LLP

Denise Olsen
Senior Managing Director,
GEM Realty Capital Inc.

Neville Rhone
Managing Partner,
Arc Capital Partners

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Morning Breakout Session

Successful Emerging Managers

Larissa Herczeg
Managing Partner,
Oak Street Real Estate Capital

Peter Braffman
Managing Director,
GCM Grosvenor

Paul Verbesey
Partner,
Goodwin

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Afternoon Breakout Session

Driving NOI in Tight Markets

Keith Harris
Senior Vice President,
The Bozzuto Group

Michael Schwartz
Principal,
RSM US LLP

Jeb Scherb
Partner,
Ameritus LLC

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Afternoon Breakout Session

How Co-working Is Revolutionizing the Office

Michael Burke
Director of Real Estate,
Convene

Matthew Ward
Senior Managing Director,
Newmark Knight Frank

Richard Heby
Marketing,
LiquidSpace

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Afternoon Breakout Session

Amazon-Proof Retail

Andrew Shepard
Director,
RINET

Marc Wilkow
President, CEO, & Principal,
M & J Wilkow

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Keynote Interview

Emerging Markets: It's Time to Take a Fresh Look

Tom Heneghan
Chief Executive Officer,
Equity International

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Panel Discussion

The Rise of the Real Estate Debt Asset Class

Peter Sotoloff
Chief Investment Officer,
Managing Partner,
Mack Real Estate Credit Strategies

Roger Cozzi
Chief Investment Officer,
Commercial Real Estate Debt,
AllianceBernstein LP

Lance Wright
Managing Director,
ACORE Capital

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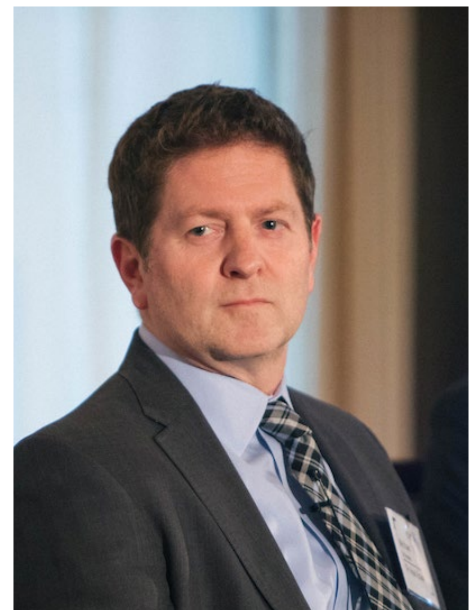
Panel Discussion

The Right Strategies for Deploying Capital in a Frothy Market

Peter Borzak
CEO & Chairman,
Pine Tree, LLC

Sujan Patel
Managing Director,
Co-head of U.S. Investment Management,
Colony NorthStar



Michael Schwaab
Senior Director,
CASA Series & Student Housing,
TH Real Estate

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How to Make the Back Office a Competitive Advantage

That's right—fund administration can take a real estate fund to the next level

The maturation of the alternative asset investment industry has propelled the growth of many related service providers, but few have grown as rapidly and with such significant impact as fund administration.

In the last decade, as general partnerships grappled with the regulatory and investor-driven changes to the marketplace, firms have had to meet more rigorous reporting requirements and demonstrate greater transparency—all while finding investments and structuring deals in a competitive business environment.

While these added responsibilities may be viewed as an onerous distraction from a firm's primary investment mission by some general partners, fund administration can be done to competitive, cost-saving advantage.

Many administrators have developed the capability to provide cybersecurity, investor onboarding, and enhanced compliance services to asset managers, elevating their role from back-office functions to being an integral part of a firm's competitive profile. The next level is the ability of the fund administrator to amass and then analyze a huge volume of data that can directly support the fund's most important activity—making good investments.

Michael Halloran, chief executive of fund administrator NES Financial, which has particular expertise in EB-5 and 1031 exchanges, explains: "When you look at private equity and particularly alternative assets today, you have a whole ecosystem of providers out in the marketplace. These are your traditional fund administrators, so back, middle, some front-office services. But in reality, they're like plumbing. Fund administration needs to become much more strategic."

The Transition

The financial crisis of 2008 and the multibillion-dollar Bernie Madoff fraud scandal reinforced the need for outside administration, a trend supported by regulators and investors, says John Phinney, CEO and co-president of business intelligence firm Convergence.

"There was already something of a movement, and post-Madoff, most investors said to their managers, 'You need to use a third-party administrator—I am not gonna get burned.'" Convergence's own data suggests that 92 percent of U.S. hedge funds, for instance, now use third-party administrators.

The industry is rising to the challenge and expanding the administrative functions that managers can outsource. Technological innovation has helped this rapid expansion, according to Michael Wilson, chief financial officer of Chicago Pacific Founders, a private equity firm specializing in healthcare. When he started his career in the early 1990s, he recalls, his firm needed an outside consultant to provide an internal-rate-of-return function in its Excel spreadsheet program, and the calculations took an hour or more. Now, he says, off-the-shelf software does the same thing in less than a second.

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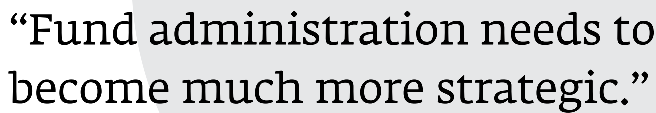

> “Fund administration needs to become much more strategic.”
>
> –**Michael Halloran**, NES Financial

As automation increases efficiency, though, the combination of new reporting obligations and market competition has piled more responsibilities on a fund CFO’s plate. Halloran says fund operation now requires superior capacities for accessing and retaining capital while finding opportunities to deploy it. Administrators like Halloran are developing technologies that not only help with the basics—proper reporting and controls, etc.—but transform the back office into a source of strategic advantage.

“Imagine if you had that environment fully integrated, where you could take data from internal performance data on the fund to external data within the sector, maybe within a particular region, and be able to analyze all of that data in real time,” Halloran says. “That’s fundamentally different than anything that’s delivered out in fund administration today. The best funds out there are going to be better, faster, and smarter than the other guy, because they’re able to take data from disparate sources, pull it together, and turn it into actionable intelligence. The delivery mechanism for that is going to be the fund administrator.”

Converging on Cost Controls

Beyond the potential competitive advantages as they relate to the investment process itself, cost controls are an increasingly significant factor in the advantages conferred by top-tier-fund administration. As asset managers respond to investor pressures to keep costs down and rein in non-core, non-revenue-generating expenses on the operations side, administrators have expanded their services to provide workflow and expense-tracking options that improve transparency and reporting efficiency.

Halloran estimates the annual infrastructure costs of private equity general partnerships at $35 billion a year, and investors are pressing for reductions. “Those costs have to go down, and the value has to become higher,” he says. “They have to be able to do more with less.” Halloran speaks from experience. His firm manages seven times the number of limited partners, and 3.5 times the number of funds per employee, that the leading industry players do, as ranked by AUA.

Phinney, at Convergence, sees expense management opportunities as a major factor in hiring administrators, particularly by managers with funds that are domiciled overseas or have sizable numbers of foreign investors.

“Every advisor will tell you they’re not in the business of running infrastructure—they’re in the business of investing,” he says. “So if I am looking to expand my business, having an administrator who has a presence in an overseas location, that’s record-keeping and compliance requirements I don’t have [to do internally].”

New Rules, Same Goal

Wilson, at Chicago Pacific, welcomes the improved communication and closer relationships with limited partners now embraced by most alternative asset managers. Next-generation fund administration helps strengthen those relationships and position a manager for future success. And with administrators able to quickly and easily report detailed metrics like the total value per invested dollar and distributions per invested dollar, the investor side is better informed and more discerning today than in the pre-crash era.

“In old days, if you invested in one of the mega-funds, it was like putting your money in a black box that came out the other end,” he recalls. “Some of them used to report [to their LPs] once a year. I don’t know that you could get away with that right now.”

Much as they can’t get away with viewing fund administration as just another expense. ■

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Six RE Fundraising Trends You Need to Know Now

Insights from Goodwin's Matt Giles

1 Large Investors Demand Co-investment Priority

Increasingly, sovereign wealth funds, pensions, and other large institutions are demanding priority for co-investment from their investment managers. They're seeking lower fees and more control, and many of their managers are acceding to their requests.

This can add a layer of complexity to a fund; these deals often are negotiated as side letters to the limited partner agreement and can increase administrative and reporting burdens. It also requires an extra layer of transparency, because smaller investors want to make sure they're not getting the short end of the stick.

In response to the increased demand, some managers are creating standalone vehicles with the aim of expediting the process. In practice, one of the main challenges of co-investment is timing—sponsors often need their co-investors to act quickly.

2 Investment Allocation Policies Are Top of Mind

As investors have become more sophisticated, investment allocation policies have become increasingly important.

That's particularly so when a manager runs multiple real estate vehicles and the strategies of those vehicles overlap. Investors (and regulators) want to make sure there's a clear process for allocating investments to each vehicle. Oftentimes the policy is based on "rotation," with each vehicle getting an investment in turn.

These policies have taken on greater significance as managers look to expand their offerings in the form of separate accounts. All investors want to know that you're focusing on their investments, and a transparent allocation policy can set them at ease.

3 "End of Life" Issues Are Being Negotiated Now

The real estate world is still dealing with the fallout from the financial crisis, particularly for funds closed in the 2005-2009 period. The lesson: Investors and managers need to think through what happens when the typical 10-year fund cycle nears its end.

When that happens, the fund needs to consider how it will handle everything from fees to possible liquidation. Some issues are easier than others. For instance, if a building is being sold late in a fund's life and that sale requires keeping adequate cash on hand for a period of time, managers and investors can typically come to an agreement in real time to accommodate the sale.

Issues like fees can often be addressed up front, with the understanding that things can always be renegotiated as circumstances change.

4 Managers Want Longer Investment Periods

Managers are seeking more flexibility in deploying capital. That flexibility is meant to boost returns—no manager wants to be forced into subpar deals due to an arbitrary timeline. Investors, on the other hand, are sensitive about paying fees, particularly commitment-based fees, and longer investment periods can mean higher costs.

Most funds still operate on the typical four-to-five-year investment period, but those who have been successful in lengthening it point to the financial crisis to show how flexibility can be particularly useful in times of distress.

5 The "Key-Person Clause" Is Key

Investors are increasingly asking managers questions about the GP's internal structure. How do you share carry? Who makes decisions? Succession issues cause even more anxiety. If the founder gets hit by a bus, who's calling the shots? Such questions inevitably lead to a discussion of the so-called key-person clause and succession planning. Many older real estate funds are looking to expand their key-person provisions to reflect the growth and development of the firm and demonstrate that it's not a one-person show. But it's a delicate balance, as investors like continuity. The best managers are actively engaged with their investors, showcasing and introducing the next generation of leaders well before it's time for them to take over.

6 The Use of Credit Under Scrutiny

Subscription credit facilities have long been used in real estate—managers like them because they can conserve investor capital to fund expenses and deals. But one potential downside for investors is that by delaying capital calls, managers may get into the promote earlier than they would otherwise.

Gone are the days when a fund could delay all capital calls until a final closing to pump up fees, as investors typically require restrictions on how borrowings can remain outstanding. The SEC is actively monitoring funds to make sure proper disclosures are made—not just that a manager has a credit facility, but how they use it, and how it impacts their returns and compensation. ■

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