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CFOs & COOs Forum
New York 2020

April 29 - 30 | Convene, 730 Third Ave.

News Compendium

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CFOs & COOs Forum
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Navigating operational complexity and scaling your organization

Keynote speaker

Reisa Bryan
Global Chief Operating Officer
Nuveen Real Estate

Reisa leads investment governance and operations, supports the planning, coordination and execution of U.S. business process and initiatives. Reisa is a member of the Global Executive Leadership and the Americas Executive Leadership teams and also serves as the chief of staff to the head of Nuveen Real Estate, Americas and is the central point of contact for senior leaders.

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Managing Director
and Head of Finance
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Manager
**Broadstone Real
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Hans DeWitte
Managing Director and Chief
Financial Officer
Prospect Ridge

Melissa Gliatta
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Thor Equities Group

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Basis Investment Group

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Deep Dive: How ESG will become a CFO issue

Sustainability is turning into a numbers game and moving into the finance chief's wheelhouse, write Toby Mitchenall, Brian Bonilla, Philippa Kent and Connor Hussey.

Every year a team from LGT Capital Partners, a global fund investor, collates qualitative data from more than 300 of its general partners and converts it into a quantitative scoring system. Managers emerge from the process with a grade of between one and four which tells them – and LGT – how they rate with regards to environmental, social and governance issues.

To achieve a score of one (the best), a manager must demonstrate "genuine" commitment to ESG and have institutional processes in place, applying ESG criteria to investment decision-making, ownership and reporting. Managers who demonstrate little or no commitment to ESG – scoring four – are "encouraged to improve over time," according to the firm's annual write-up of the results. Another global fund investor, Pantheon, applies a green-amber-red ESG risk rating to its managers. Ratings are arrived at through an operational due diligence questionnaire – around eight or nine "relatively open-ended questions" – and then further conversation with the GP's investment team, says Alex Scott, a partner in the investment team and member of the five-person ESG steering committee.

That these two fund investors are Europe-headquartered – LGT on the edge of Lake Zurich in Switzerland and Pantheon in the City of London – is significant. Europe has been the epicenter of ESG.

"We have seen the greatest capabilities in being able to report ESG-related data out to investors among European GPs, because European LPs have been asking for it," says Andrea Auerbach, head of private investments at consultant Cambridge Associates.

> ***"It has now spread to North America and is going viral."***
>
> Andrea Auerbach
>
> **Cambridge Associates**

"It has now spread to North America and is going viral."

This was certainly true for Genstar Capital, a San Francisco-based firm with $17 billion in assets under management and a history stretching back to 1988.

"We probably thought about ESG more in response to our European investors being thoughtful about it," Genstar managing director and chief financial officer Melissa Dickerson explains. "Europe has done a good job of leading the way here."

JOINING THE CLUB

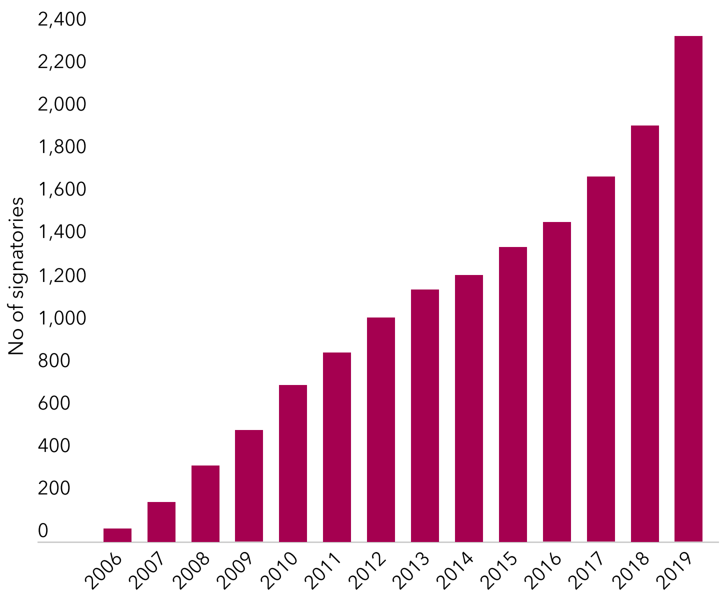
Genstar became a signatory of the United Nations' Principles for Responsible Investment in 2015.

Being a UN PRI signatory requires a firm to formally apply and pay an annual membership fee. It also has to report on its responsible investment activity within the first 24 months of signing up. This has become an important indicator for many prospective LPs of a manager's commitment to ESG; it is alluded to, for example, in both Pantheon's and LGT's assessments.

There are now nearly 2,400 organizations (both asset owners and managers) signed up to the UN PRI. This proliferation – ostensibly a good thing as it shows widespread engagement with ESG – is also making it less of a useful indicator and more of a "tick the box exercise," said Maria Sanz Garcia, managing partner of Munich, Germany-based fund investor Yielco Investments, at an event in October. "Everyone has an ESG policy and is a signatory. Everyone does that in Europe."
Sanz Garcia contrasted her dealings with European and US GPs: "We invest a lot in the US in smaller managers, and when you ask them about ESG, they often ask,

WE ARE ALL RESPONSIBLE

The number of signatories to the UN PRI is rocketing



Source: UN PRI

'What does ESG mean?' If you go to the southern part of the States it is worse."

Sanz Garcia's dismissive take on US GPs' ESG engagement is reflected in the data that LGT publishes on its managers. In the firm's 2019 report, 79 percent of European managers scored either one or two (the top grades), while only 49 percent of US managers achieved that grade. To put it another way, 25 percent of the US managers LGT works with demonstrate "little or no commitment to ESG." A further 26 percent showed some commitment but lack institutionalized processes.

One reason that the adoption of ESG policies and procedures has been slow to take hold in the US is that systematic data-driven scrutiny by LPs of it is still in its infancy, even among some of the most sophisticated private markets investors.

NO POLICY? NO PROBLEM

At the Alaska Permanent Fund Corporation, Marcus Frampton, chief investment officer of the $65.3 billion state sovereign wealth fund, says evaluating ESG is "qualitative as opposed to formulaic."

"At some point, we may look at formalizing some sort of an ESG policy," says Frampton. "But today, it's simply that we review managers' approach to ESG on their prior investments, just as we'd evaluate their responsible use of leverage, the reasonableness of the valuation decisions they make, etc."

"The short answer is no," to whether the $139.6 billion Washington State Investment Board looks at ESG ratings when evaluating a firm, according to Chris Phillips, a spokesman for WSIB.

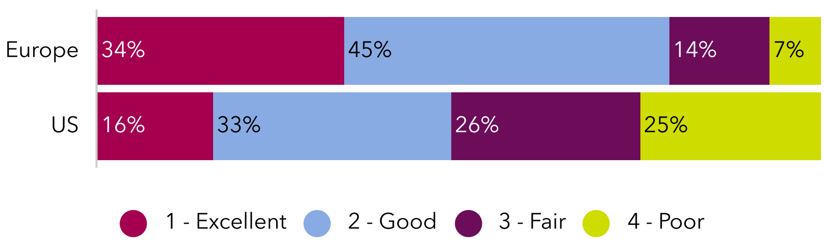
"Our asset class teams individually are responsible for evaluating all material risk factors as part of their due diligence," Phillips says. "The WSIB has not adopted a single position or practice regarding various ESG ratings or metrics systems."

But the direction of travel is only in one direction. WSIB is reviewing its ESG-related mapping and measurement frameworks ahead of a planned hiring of a sustainability officer next year, adds Phillips. The Rhode Island State Treasury in October hired consultancy Wilshire to advise it on how to incorporate ESG into its private markets investment processes. Like Auerbach said: it's going viral.

So what does it mean for a GP to integrate ESG reporting? The short answer is: different things

US VS EUROPE

ESG ratings by region in 2019



Source: LGT Capital Partners

to different firms.

Genstar works with consultant Malk Sustainability Partners. "With their help we worked with lots of investors to develop checklists and templates that are specific to different industries," says Dickerson. This means that while an industrial business might be required to measure outputs relating to carbon or waste, a services business might be assessed on a different set of metrics. "It's going to be different for different industries and it's evolved to include lots of things like data privacy, diversity and inclusion etc."

Genstar engages Malk whenever the firm is conducting due diligence. "They'll talk to the management teams and look at the data rooms and give us an assessment," says Dickerson, "which we'll then incorporate into our investment committee process. If there are already red flags, we'll know about them before we buy a company. But it gives us a good baseline, because if you do end up buying the company, this is where you start."

Finally, there is an annual monitoring piece – again undertaken by Malk. Says Dickerson: "We'll also engage them upon exit so that we have a picture of the round trip during our hold period. This shows the kind of impact we might have had on the ESG paradigm from start to finish."

Dickerson includes summaries of the ESG updates in the firm's annual report.

OIL-Y ADOPTER

Houston-headquartered EnCap Investments is one of the largest private equity firms in the world. The energy specialist closed its 11th flagship fund on $7 billion in 2017 and last year raised a further $3.25 billion for its fourth midstream fund. The firm first instituted a responsible investment policy in 2008 and then created a standalone ESG policy in 2012. The firm is now working on standardizing ESG reporting from its portfolio companies so that it can aggregate the data and report fund-level ESG performance.

"For example, there is a standard template for diversity that portfolio companies can fill out,"

> ***"What it does is really focus on constant improvement of the ESG process in all areas and give us a base in order to measure that improvement and be able to determine that in fact goals are being met."***
>
> Bobby Haier
> **EnCap Investments**

Craig Friou, EnCap's deputy CFO says. "By conforming to a standardized template we can add it up across all our funds – or by individual funds – to provide meaningful reporting to our investors."

This year will be the first of reporting "and that will be the baseline data," says Friou. "Just having that information is the first step to making good decisions."

Says the firm's CFO, Bobby Haier: "What it does is really focus on constant improvement of the ESG process in all areas and give us a base in order to measure that improvement and be able to determine that in fact goals are being met."

The templates – which are 20 questions long – were based initially on the due diligence questions that some investors were asking for during fundraises. "If they were asking for information in a certain way, that was probably a good indication of how we should be collecting and reporting it," says Friou. "In terms of examples, we are an energy manager, so the two top topics are greenhouse gas emissions and use of water."

Friou road-tested the templates with portfolio companies and they fed into the design, highlighted where questions would be hard to answer or perhaps would not yield the right information. "I just took all the feedback and after going back and forth for a couple months, finally landed on the final version. I imagine it will always be updated and refined and improved every year," he says.

The ESG data are gathered through OneSource, a Thomson Reuters-owned disclosure management software.

As of October, EnCap has joined the swelling ranks of PRI signatories. "I think there was a desire to do things as an industry rather than to be rogue and out doing things on our own," says Friou. "When we looked at all of the different groups that were doing similar things, I would say PRI stood out as the most prominent one with the greatest amount of participation. They offer a lot of resources, a lot of networking opportunities. When we looked at the reporting, we thought it was balanced as far as having granular and meaningful information but not being too burdensome."

Cloverlay, a mid-market private equity firm that invests in "adjacent private markets," has had an ESG policy since 2017. "The reasons were two-fold," says principal and CFO Omar Hassan. "We wanted to think about it critically and have an answer for our stakeholders. To us it just makes sense to have one, regardless of where you are in the spectrum of ESG, mainly for transparency. It is something we want to codify as part of our process."

It was not something that LPs had specifically asked for, continues Hassan.

In terms of designing the policy, Hassan, the firm's legal counsel and the senior investment professionals sat down and said: "Okay, what are we actually doing when assessing an energy deal or a transportation deal or something that can potentially run into some of these issues?

"We worked with our compliance consultant [Adherence] and our legal counsel to see what is acceptable from a regulatory perspective and we relied heavily on them to help us think through the actual language.

"We took the stance that we're going to leave it high level. The policy doesn't go into scenarios or specifics, but it lists out certain procedures where we could evaluate certain factors. We try to gather qualitative and quantitative information."

ESG policy and implementation does not always fall into the CFO's remit. Three of the firms Private Funds CFO spoke with say it is the domain of someone whose background is in external relations, marketing or IR. One such firm is Central and Eastern Europe-focused Abris Capital. Partner and CFO Steve Richmond is responsible for investor reporting, while IR and comms head Monika Nachyla has spearheaded the creation and rollout of the firm's ESG policy over the last two years.

Richmond says that while he is not too involved, this could change if the firm gets to the point where it is doing "more frequent, more detailed" reporting to the investors.

> ***"What will probably end up happening is standardized metrics will start being more regular."***
>
> Omar Hassan
> **Cloverlay**

That "more frequent, more detailed" reporting of ESG data is coming. The industry is at a stage now where "table stakes" for raising capital from sustainability-minded institutions is an ESG policy and willingness to engage. This will not be the case for ever.

According to EnCap's CFO Haier, the future is "providing more quantitative data where you can show measurable improvement across the portfolio by fund. That's what LPs want to see. They want to see an improvement quarter to quarter, year to year."

"What will probably end up happening is standardized metrics will start being more regular," says Cloverlay's Hassan.

CHERRY-PICKING

The current state of affairs allows flexibility for GPs to choose how much to report and how often to do it, which leaves the door open for managers to cherry-pick examples of favorable outcomes, while burying unfavorable ones.

While pressure from investors is forcing some firms to acknowledge the need for a framework around ESG considerations, it is unlikely that this pressure alone – patchy as it is – will move the needle. Less than a quarter of investors surveyed as part of sister title Private Equity International's LP Perspectives survey described evidence of ESG consideration as being a "major" part of due diligence. Most (55 percent) said it forms a minor part, while 22 percent said the matter was not covered at all in due diligence at all.

So what will convert ESG into a data-centric exercise? Regulation will likely play a large part.

At a high level there is evidence that the Securities and Exchange Commission is taking an interest in how managers describe and adhere to ESG policies. Elsewhere, it is likely that individual elements of ESG will be the subject of issue-specific law. Take for example the law in the UK that now requires companies with more than 250 employees to publish the data on gender pay balance. How long will it be before mandatory reporting requirements are brought in relating to energy or water usage?

"Discussion of ESG reminds me of the early days on the internet, when it was talked about like an amorphous unified cloud-like entity," says Cambridge Associates' Auerbach. The needs for accurate and timely data will coalesce around individual topics, rather than ESG as a uniform concept.

The concept of integrated reporting of financial and extra-financial data is discussed frequently among ESG specialists, says Keimpe Keuning, an executive director at LGT heavily involved in its ESG efforts: "We are a long way from global standards, but it is getting a lot of attention. This should be the ultimate goal."

There is also the prospect of financial rewards – beyond the benefits of good risk management – linked directly to sustainability performance. In October Dutch bank ING launched what it described as the first capital call facility with an interest rate pegged to ESG performance targets for the fund portfolio companies. In Spain, the private equity association, ASCRI, is currently working with local governments to see if there is a way of linking tax incentives to sustainability.

Further into the future, the influence of impact funds will start to be felt. Mainstream private equity investing could include a direct link between the attainment of sustainability goals and the amount of carried interest a GP is entitled to. This is already the case with some impact funds, said Yielco's Sanz Garcia. "We would like to see funds having measurable goals in the way that impact funds do. They have impact goals that are measured, and they are linked to their compensation," she said, adding goals could relate to any ESG measure, such as energy usage or diversity. "As we move forward, this could be the next step of ESG."

For now however, it is up to individual GPs how far up the ESG data curve they travel. As one CFO put it to Private Funds CFO: "We are implementing a new portfolio management tool at the moment, and at the back of our mind is that at some point we will have to collect that [ESG] data … but it isn't something we need to do immediately." ■

IS THE SEC INTERESTED IN ESG?

One of the great things that our colleagues on Regulatory Compliance Watch do is share with subscribers recent document request letters (redacted) from the SEC's Office of Compliance, Inspections and Examinations.

In a recent batch was a letter digging deep into one advisor's approach to socially responsible investing, or environmental, social and governance-related investing.

One item requested by examiners from the SEC's Los Angeles regional office were details of any proprietary scoring system or third-party scoring system.

"I would suspect the SEC would focus on three fundamental questions relating to scoring systems," says Ken Berman, partner at Debevoise & Plimpton. "Do you have a scoring system? Have you represented that you will have a scoring system and if so, did you follow it consistently?"

Another focus of the letter had to do with whether the advisor "adheres to the UN Principles for Responsible Investment," and if so, provide documentation of the use of these principles when making investments and managing portfolios. The wording for this inquiry is key, says Berman. "I don't think this is a tacit endorsement by the SEC of those principles. I think they're focusing on a set of principles that they may sense are either being widely used or that people are suggesting that they'll follow. If you use the principles as guide but don't exactly follow them, the SEC will likely want that explained."

Other aspects of the letter included questions on the advisor's definitions of the terms ESG and SRI, their policies and procedures for deciding whether an investment fits these criteria; a list of clients with ESG/SRI investments; research and due diligence files from the advisors three best and three worst ESG/SRI trades; and any ESG-related marketing materials or industry award wins.

In this letter the SEC is clearly focused on transparency and disclosure but is that enough to prove the agency is now focusing on ESG matters? Private Funds CFO requested clarification from the commission, but it did not respond.

"I don't have the sense that this is a high priority at the SEC right now, or that it's at the top of their regulatory priorities," says Isabel Dische, a partner at Ropes & Gray, who has received similar questions from clients that were issued a similar letter directly or came across them indirectly. "I think to a degree the questions of investment strategy, marketing materials, and policies and procedures are questions that the SEC has raised independent of ESG."

Deep Dive: How investors are rethinking ODCE

Investor appetite for the US flagship fund index is in flux, giving rival funds and strategies an opportunity to muscle in

By Kyle Campbell

One of the oldest and most successful open-end diversified core real estate funds in the market, UBS's Trumbull Property Fund, stands as a testament to what happens when the model goes awry.

Launched in 1978, the fund discloses $25 billion of assets in its most recent filing with the Securities and Exchange Commission. Its gross rate of return since inception is 8.9 percent, according to a meeting document from the US pension plan Ventura County Employee's Retirement Association. The return beats the industry's leading benchmark, NCREIF's ODCE fund index, by 23 basis points.

However, the Swiss bank's marquee core fund is dealing with a steadily growing queue of redemptions, which, at last count, neared $4 billion, according to sources familiar with the fund. Some investors will have to wait years for their capital to be returned. The more investors tap out, the more assets must be liquidated, meaning less capital for UBS to return to its remaining investors, incentivizing them to, in turn, trigger their own exits. With outside investors reluctant to subsidize those departures, new commitments have not been able to match redemptions, prolonging the delay.

UBS Trumbull is a stark example of what can happen when investor sentiment turns against an open-end real estate fund. But it is not the only struggling diversified core vehicle in the market. Others, particularly those in the US market, face notable redemption requests and sector returns have diminished over the past five years.

Joe Azelby, UBS's head of real estate, declines to comment on Trumbull's redemption queue, or the efforts to reposition the fund.

However, he acknowledges that allocations to ODCE index funds are tapering off as projected returns have faltered after several years of strong post-global financial crisis performance.

"Investor interest in ODCE funds ebbs and flows based on capital market conditions, interest rates, strategic and tactical allocation changes and risk appetite," he tells PERE. "It's been a great run for core real estate and returns in this area will likely be lower going forward."

Through interviews with 18 investors, managers, consultants and research firms, and review of various US public pension investment documents, PERE has found a broad rebalancing of core portfolios is taking place. Many investors are working to align their allocations with market trends. Typically, this means pulling out of funds that lean heavily on retail and office assets in favor of those with more industrial and multifamily biases.

"There's been an unusual amount of variability in returns between ODCE funds and that has caused consultants and their clients to look more closely at portfolio construction," Jim Garvey, portfolio manager of Chicago-based LaSalle's open-end LaSalle Property Fund, tells PERE. "It seems there is more reallocation in this space than normal."

These portfolio changes reflect a more hands-on approach taken by US investors. Oftentimes at the advice of their consultants, more institutions are exerting greater control over their real estate holdings. The market has responded by offering regional and sector-specific core funds, some of which fall outside the four traditional property types. These open-end vehicles also appeal to non-US investors interested in building low-risk portfolios without being locked into a specific diversification plan.

A growing number of midsize US institutions are following the example of their larger peers by moving away from funds altogether and hand-picking core investments through joint ventures and separately managed accounts. "Investors don't need to have a $30 billion real estate portfolio to implement a direct strategy," Ben Maslan, managing director of the Los Angeles-based consultant RCLCO Real Estate, says. "You can implement such a strategy with the right managers and the appropriate amount of leverage with $2 billion."

Nonetheless, the US ODCE universe continues to expand despite the growing indifference of some domestic investors. The total market was at $202 billion of net assets in Q2 this year, up from $190 billion in Q2 2018 and $169 billion in Q2 2017. The consensus is this trend will continue for the foreseeable future, especially as more Asian investors, keen on open-end structures, enter the US market.

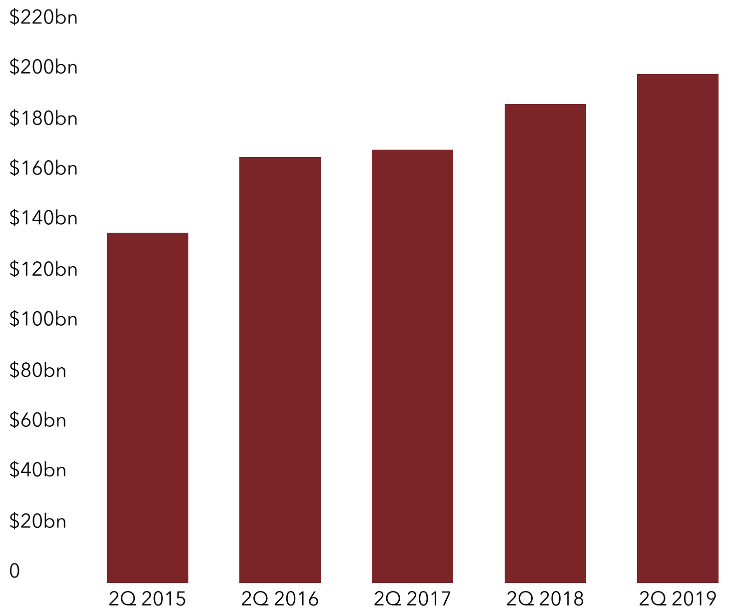
However, UBS Trumbull's travails serve as a reminder that perpetual-life structures can bring challenges. As investor preferences change and new products come to market, ODCE funds could find their allure diminishing further in the years to come.

CORE CHANGES

Core property remains crucial to most institutional investment

STILL GROWING

US ODCE funds continue to add net assets



Source: *NCREIF Fund Index - ODCE*

strategies. Almost 80 percent of real estate assets globally are regarded to be core, according to the Pension Real Estate Association's 2019 Investment Intentions Survey. Among the survey's Asia-Pacific investor respondents it is more than 90 percent.

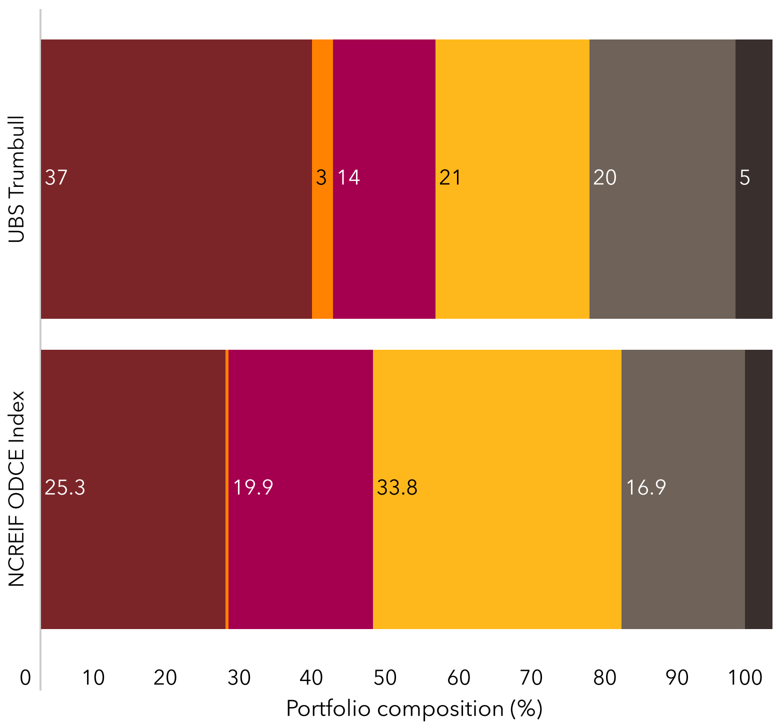
Yet, not all core assets or allocations are equal. US investors are exiting vehicles that are overweight in sectors or locations that break with their view of the market. The top reason given for Trumbull's redemptions is its exposure to retail properties, which account for 23 percent of its portfolio, compared with 17 percent for the NCREIF ODCE fund index.

In light of the well-documented struggles of second- and third-tier malls, investors want to limit exposure to retail assets, which delivered a total return of -0.11 percent during the second quarter, according to the NCREIF Property Index. Demand is shifting toward logistics properties to take advantage of rising e-commerce activity. Accordingly, Trumbull's returns, which lagged the ODCE index by 1.4 percent over the past one-, three- and five-year periods, according to VCERA meeting documents.

"Within and even beyond ODCE, we have investors with an increased appetite for strategies that can give them exposure to high-quality residential and industrial assets in their portfolios," Bernie McNamara, co-head of investor services and solutions at Los Angeles-based manager CBRE Global Investors, tells PERE.

OUT OF ALIGNMENT

UBS's Trumbull Property Fund has fallen out of step with the NCREIF ODCE index



Sources: *Ventura County Employees' Retirement Association* meeting document, March 25, 2019
NCREIF Index Fund - ODCE, 2Q 2019

Some investors raise other issues with Trumbull's allocation. The Illinois State Universities Retirement System flagged the fund's hotel allocation as one reason for its $380 million redemption request in 2018. In its 2020 investment plan for the San Diego City Employees' Retirement System, Townsend Group, an Ohio-based consultant, recommends the pension continue its withdrawal from Trumbull citing "historic underweight to outperforming Pacific region [and] office portfolio underperformance." SDCERs has redeemed $45 million from the fund so far and hopes to get the remaining $34 million in six or seven quarters, according to the July meeting document.

UBS's fund bears the brunt of the damage, but other ODCE funds with similar portfolios face redemption requests and have been placed on investor watch lists because of their similarly shaky performances. SDCERS is also eying an $85 million redemption from the AEW Core Property Trust. Townsend recommends the move based on an overweight to retail and performance that lags the ODCE index. Like other investors, SDCERS hopes to deploy its redeemed capital into other core vehicles, targeting a $65 million ODCE investment and a $50 million core-plus investment later this year.

The Ohio Police & Fire Pension Fund is undergoing a similar core portfolio reconstruction. In August, it approved redemptions of $40 million and $25 million, respectively, from the JPMorgan Strategic Property Fund and Heitman America Real Estate Trust. It plans to redeploy to LaSalle's US Property Fund and Morgan Stanley's Prime Property Fund, two of the biggest winners of the ongoing ODCE shuffle – both have commitment queues of $1 billion or more, according to a source familiar with their fundraising efforts.

Garvey says LaSalle pivoted toward industrial and multifamily with the expectation that those assets would perform better in a downturn: "There's been a lot of discussion about how long the economy's been growing and the potential for this business cycle to end, so in anticipation of that, not knowing when it will happen, we moved to a more defensive stance a few years back," he tells PERE. "The economy continues to grow, but there are a number of macroeconomic risks that are evident."

LOWER RETURNS

Through the four quarters ending on June 30, the NCREIF ODCE index tracks a total gross return of 6.4 percent, down from the 7.5 percent at the end of the previous quarter. In 2015, the index delivered 15 percent returns before falling to 8.7 percent in 2016, 7.6 percent in 2017 and 8.3 percent last year. Among the weakest funds, the decline is steepest, tumbling from 13.9 percent in 2015 to just 5.3 percent this year.

Historically, ODCE funds have delivered returns in the high single-digit range. Since inception, NCREIF tallies a return rate of about 8.7 percent. However, double-digit returns were common during much of the previous decade, particularly in the years immediately before and after the global financial crisis. Even in the doldrums of 2008 and 2009, the funds in the index retained much of their income and value, thanks to the stability of their properties and their minimal use of leverage.

Christy Fields, managing principal of Massachusetts-based consultant Meketa Investment Group, says diminished returns are not surprising: "Appreciation was terrific coming out of the global financial crisis, but no one would expect these core vehicles to produce teen returns through all parts of the cycle."

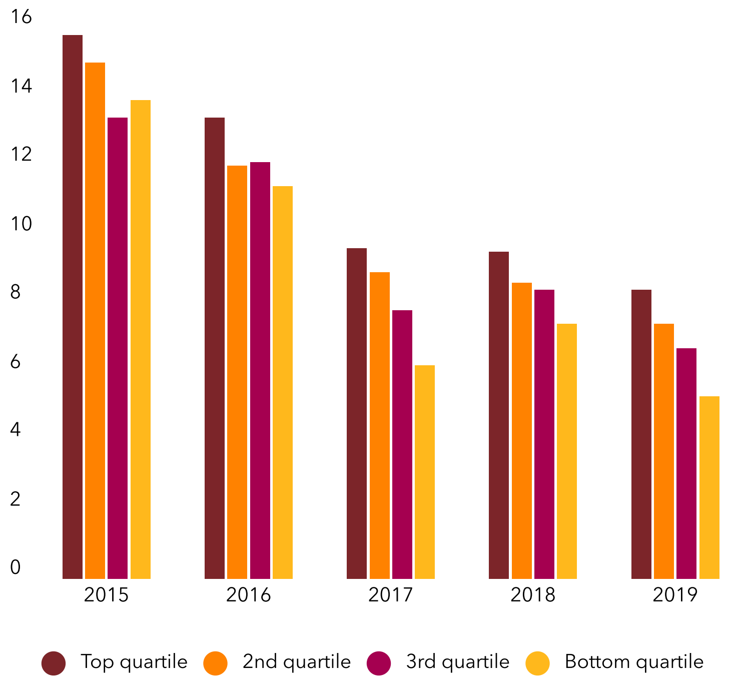
Investors are still drawn to real estate, Fields says, because returns remain strong compared with interest rates, which are exceptionally low in mature markets. "People feel good about real estate. It's just the things on the margin that are driving these decisions around rebalancing and redemption"

Some investors are fine with lower returns. Shinji Kawano, head of overseas property investment at Tokio Marine Asset Management, tells PERE the institutional capital his Tokyo-based firm invests has no problem with the risk-adjusted returns being produced by ODCE vehicles.

"We are fine with lower returns," he says. "Japanese pen-

RECEDING RETURNS

Performance has been down across the ODCE index, but some funds have fallen further than others



Rolling four-quarter returns by fund ODCE index quartile

Source: *NCREIF Fund Index - ODCE*

sion fund schemes, their typical expected return is between 2 percent and 3 percent, so they don't need double-digit returns by investing in real estate. On the local currency base, 6 percent to 7 percent is sufficient."

While the current ODCE market pales in comparison with the heady years around the GFC, that era has contributed to the space's continued vibrance, Andrew Mitro, a principal at StepStone, tells PERE.

In response to risky practices that lead to the downturn – speculative development, a reliance on recourse debt and subprime lending – many investors have adopted a more conservative approach to real estate, he says: "What you see now is investors typically have a larger core-to-core-plus allocation than they did pre-GFC. We advise one public pension plan that, prior to the GFC, was 30:70 core to non-core and out of the GFC that flipped to 70 percent core, 30 percent non-core because they didn't want the volatility of those non-core investments. It comes down to an investor's goals for real estate and the risks it's willing to take to achieve them."

A NEW TWIST ON CORE

The California State Teachers' Retirement System, for example, has a 65 percent allocation to core, equaling roughly $19.76 billion of its $30.4 billion real estate portfolio, according to its most recent semi-annual report. Just 17 percent of its holdings are in open-end funds compared with 33 percent for joint ventures and 30 percent for separate accounts. The Sacramento-based pension has bested the ODCE index by 2.4 percent, 2.6 percent and 2.3 percent over the past one-, three- and five-year periods.

While CalSTRS and its peers are no longer adding capital to their open-end core fund allocations, Mike DiRé, the pension's head of real estate, tells PERE that ODCE vehicles remain a crucial tool for smaller investors looking to build real estate portfolios. He also notes that the large diversified funds are evolving to meet investor demands for strategic diversification. "They're offering more options now," he says. "They're differentiating from each other more, so if you want an overweight toward a certain product type or area of the country, you can do that analysis and that data is a lot more available. You can pick and choose these funds and even specialized funds."

Nuveen Real Estate, a London-based manager, has taken this desire for customization to heart and is reconstructing its core platform accordingly. The firm has replaced its open-end diversified US Cities Fund with its Global Resilient Cities series, comprised of six region- or sector-specific open-end vehicles, one apiece for European cities, Asia-Pacific cities, US retail, US multifamily, US industrial and US office.

When Nuveen sought to restructure its core offering in 2016, it found that a segmented approach would allow investors to build up exposures to their liking, US chief investment officer Carly Tripp tells PERE. "It became apparent that there were advantages to that specialized approach versus a generalist approach," she says. "It was the outperformance along with investor demand, the ability to allocate across sectors, whether their intention is to replicate the ODCE with their investments, or overweight to one or more sectors."

CA Ventures, a Chicago-based manager, is taking a similar tack with its new open-end fund, CA Student Living Income and Growth, though it is focused on a single asset class: student housing. "Investors want specialists and sharpshooters," Nishant Bakaya, the firm's chief investment officer says. "Today, investors are sophisticated; they should be able to say, 'I want a student housing focused core fund' or 'I want a senior housing core fund.' They should be able to moderate their exposure as they see fit."

For decades, open-end diversified funds have dominated core investment in the private real estate space, attracting dollar-denominated capital by the tens of billions. But as investors prioritize customization and more managers introduce products to meet that preference, ODCE vehicles may lose their industry clout. However, the ability for investors of all sizes to gain market-wide exposure with a single check is an attribute yet unmatched by other structures, thus securing ODCE relevance for the foreseeable future, Jay McNamara, head of real estate at the research firm MSCI, tells PERE.

"It may shift and change, but I can only imagine a world where committing to commingled core vehicles remains an important part of any institutional real estate asset allocation, whether it's a defined-benefit US state plan, or the largest pension in the world," McNamara says. "It's always going to play an important role because of the time horizon for the risk-adjusted forecasts and exposures they're looking to achieve." ■

How real estate managers can do business with CalSTRS

The $240bn pension aims to be the 'partner of choice' for managers, operating companies and its peers in direct structures. Deputy CIO Scott Chan tells PERE how CalSTRS' 'collaborative model' is the blueprint to achieve these goals

By Kyle Campbell

For any managers hoping to appeal to the California State Teachers' Retirement System, the best route is going direct.

Like most of its peer group, the second-largest institutional investor in the US historically leaned on external managers, specifically via their commingled funds, for exposure to private markets. However, to exercise more control over its portfolio, cut fees and, ultimately, achieve better returns, the $240 billion pension is making a concerted effort to manage more assets internally.

While the system has participated in separately managed accounts, co-investments and joint ventures for decades, particularly through its real estate allocation, it has adopted a new portfolio-wide strategy that brings these alternative structures to the forefront. Known as the 'collaborative model', this approach calls for CalSTRS to play a more active role in its investments, be it through bespoke club deals, partnerships with other institutional investors, or acquiring operating companies to act on its behalf.

The collaborative model is equal parts investment thesis and branding tool. CalSTRS believes it can achieve substantial cost savings by keeping assets in-house. Justifiably so – in 2017, it managed 44 percent of its portfolio internally at a cost of $30 million compared to the $1.8 billion it paid external firms in management fees for the other 56 percent. At the same time, it also wants to send a signal to managers large and small, as well as other investors, that it is open for business, so long as the arrangement fits its terms.

"This is a vision that we want to execute across the asset classes," CalSTRS deputy chief investment officer Scott Chan tells PERE. "It's become the most meaningful implementation platform for CalSTRS and we want to be able to communicate it well to the market, to our potential partners, to our peers, to the [state] legislature, to the [CalSTRS] board and to our clients."

This past August, Chan and Mike DiRé, director of real estate, sat down with PERE at its Sacramento headquarters to discuss the collaborative

model, the implementation process and what it means for the pension moving forward. Led by CIO Christopher Ailman, the CalSTRS investment team identified the collaborative model as a system-wide priority in 2017. The decision came after an internal evaluation found that 97 percent of its non-carried interest expenses were going to outside managers. The following year, Chan was hired away from the University of California Regents where he headed the governing board's $55 billion global equities portfolio. As second in command at CalSTRS, it is his task to implement the vision.

ONE STRATEGY, MANY STYLES

All asset classes, both public and private, will fall under the umbrellas of the collaborative model, but CalSTRS will approach each allocation slightly differently. For real estate, it will focus on acquiring operating companies and forming joint ventures with sector specialists. To facilitate more co-investment in private equity, it will empower its staff to make swifter commitments. As it builds a more customized infrastructure portfolio, it plans to seek out like-minded institutions to invest alongside.

"It's not a one-size-fits-all model," Chan says. "It'd be wrong for us to have a one-size-fits-all strategy where we'd force asset classes, that may not be ready to execute different strategies, into that mold."

One of CalSTRS' biggest gripes with closed-end fund structures is their rigidity. As a limited partner, it has no meaningful say about what assets are acquired, or when they are bought and sold. With flexibility factoring so heavily into the collaborative model, Chan says he is reluctant to weigh it down with such mandates and hard targets.

On September 5, CalSTRS' investment committee rolled out its new strategic asset allocation plan. It calls for a 2 percent increase to both its real assets portfolios: real estate and inflation-sensitive, the latter consisting of infrastructure and inflation-linked securities. Targeting 15 percent and 6 percent, respectively, the committee hopes to get a premium from the two illiquid asset classes. It will offset these increases by shaving 5 percent off its public equities exposure. It will also add 1 percent to its risk mitigating portfolio. While the collaborative model was considered during the drafting of this new strategy, it was not factored into the expected results. Its annual return target will hold steady at 7 percent.

"We have not included the benefits of better implementation or active management in determining our new strategic asset allocation because we want to be conservative in the return/risk forecasts," Chan says. "Instead, we're forecasting 'beta' returns, risk and correlations on a very long-term basis and applying the collective wisdom and judgement of the team to come up with a strategic asset allocation."

The real estate team hopes to hold 70 percent of its assets in long-term structures; private equity will try to double its co-investment exposure from 7.5 percent of its allocation to 15 percent – which would equate to a jump from $1.6 billion today to $3.2 billion – and, overall, Chan hopes CalSTRS will save between $300 million and $500 million over the next five years. Otherwise, unlike the strict, visible framework of the fund's strategic asset allocation and its 500-plus benchmarks, this philosophy will largely play out behind the scenes.

"This isn't a model that is closed," DiRé says. "It's not like we're getting rid of all our manager relationships, or we're only open to a certain structure going forward. CalSTRS is open for business and we just want to take a more progressive thought toward the way we structure relationships going forward across asset classes."

CalSTRS' real estate team has set the standard for the collaborative model. It launched its debut separately managed account in 1987 and joint venture in 2002, according to May meeting documents. In 2007, it purchased its first operating company. As of March 31, 95 percent of the fund's core real estate was held in what it considers active structures and it has consistently beat its benchmark, the NCREIF Open-end Diversified Core Equity index. CalSTRS' core portfolio has achieved one-year net returns of 8.47 percent, three-year net returns of 8.72 percent and five-year net returns of 10.39 percent, compared to 6.55 percent, 7.01 percent and 9.18 percent, respectively, for ODCE.

Among CalSTRS' top 15 real estate managers, 12 offered a direct investment structure, including its top two managers, Principal Real Estate Investors and CBRE Global Investors, which manage $5.6 billion and $3 billion of its equity, respectively. Principal has achieved a 7.3 percent internal rate of return since inception, while CBRE, which makes direct investments on behalf of CalSTRS, has produced 5.4 percent. Other non-fund managers, including BlackRock, GI Partners and JPMorgan, have achieved IRRs of 10 percent or better. Predictably, so too has Blackstone, private real estate's current sector champion and CalSTRS' largest discretionary fund manager.

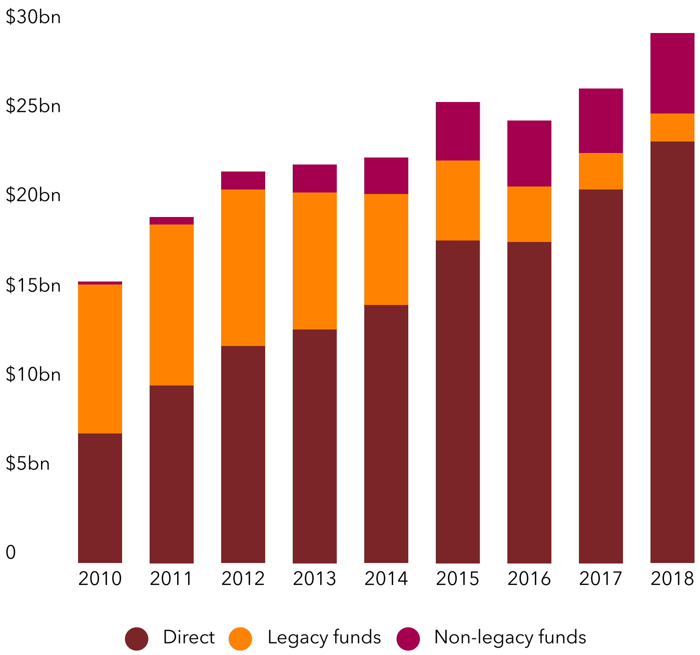
Overall, CalSTRS' top 15 real estate managers, which account for 81 percent of its net asset value, have an estimated weighted average IRR of 7.7 percent since inception, according to meeting documents, compared to the 5.7 percent produced by the portfolio at large.

Moving forward, most collaborative model investments will focus on lower risk strategies, Chan says. However, having a closer alignment with its managers will allow CalSTRS to "create a better and more intentional risk culture" by more easily comparing investments across asset classes.

"In the margin, we can understand the risks we're taking against our strategic asset allocation, what return we're getting and if they are commensurate with what we expect, or if we should be doing something else," he says. "It allows you to create a common language to compare across assets and have your asset classes compete against each other."

CONTROL SHIFT

CalSTRS is committing more of its real estate allocation to non-fund structures



Source: *CalSTRS 2018 Semi-Annual Report, RCLCO Fund Advisors*

THE 'PARTNER OF CHOICE'

To participate in more direct transactions more frequently, CalSTRS will need to increase its capacity to find, underwrite and execute deals. It plans to beef up its investment team over the next five years, possibly growing the staff from 180 to more than 300. But that would be just the tip of the iceberg, Chan explains.

"For the organization, it's a bit like throwing a pebble into a pond and seeing a ripple effect," he says. "If we're growing our investment organization, we're going to need more legal sup-

PREFERRED PARTNERS

Twelve of CalSTRS's top 15 managers use non-fund structures

Manager	Structure(s)	Strategy	NAV (mm)	% of RE portfolio	Since Inception IRR
LaSalle	SMA/JV	Office	$922	3	7.6
JPMorgan	SMA/JV	Office	$982	3	10.6
Lionstone	SMA/JV	Office	$1,440	5	8.7
ING Clarion	SMA/JV	Office	$1,516	5	8.9
GI Partners	SMA/JV	Residential	$1,576	5	11.2
BlackRock	SMA/JV	Residential	$1,862	6	10.6
CBRE	SMA/JV	Office/industrial	$3,064	10	5.4
Principal	SMA/JV	Industrial/retail/student housing	$5,572	19	7.3
Fairfield	Platform	Residential	$943	3	7.7
Pacific Coast Capital	Platform	Residential/office/retail	$1,423	5	4
Beacon Capital	JV	Office	$984	3	3.7
Fortress	Fund/JV	Debt	$773	3	2.4
Divco	Fund	Office/multiple	$657	2	9.4
Invesco Core Real Estate USA	Fund	Multiple	$667	2	6.4
Blackstone	Fund	Multiple	$1,951	6	10.6
Fund total			$30,408	100	5.7
Subtotal/weighted average			$24,333	81	7.7

CalSTRS 2018 Semi-Annual Report, RCLCO Fund Advisors

port, more tech support, more procurement support, et cetera, et cetera. This is an effort where we need to get to a point where we become more and more the partner of choice. And to do that, it's a whole organizational effort."

In addition to attracting more talent, CalSTRS also is committed to retaining it. As Chan notes, it would be difficult for partners to throw support behind an organization with frequent turnover. However, this is easier said than done, as investment professionals that rise through the pension ranks often draw the attention of private employers capable of paying higher salaries with better incentives.

Herein lies a central issue for CalSTRS and other public pensions interested in building robust internal investment teams: they must spend on compensation, travel and other expenses to save money in the long run. In the US, where top talent has plenty of options and constituents are wary of government spending, staff pay has proven to be a difficult hurdle to clear.

Despite broader constraints on staff pay, DiRé says CalSTRS has been well supported in its efforts to buck the trend. "The board has been very progressive over the years to move in the direction of creating salary structures that work." Continuing to do so is imperative, Chan says, to building a team worthy of the partnerships it seeks and to keep pace in what is an increasingly competitive field.

"If we looked at a peer group in APG, GIC, any of the Canadian funds, they have more people, they're moving faster than we are and they don't have any of the rules or regulations that we have to work within as a state agency," he says. "Their only rule is to make money."

The CalSTRS compensation committee is reviewing the system's pay scales too, according to the fund's meeting documents. It plans to adopt new salary ranges for investment managers in March 2020 then implement them the following July.

Other pension funds that have pursued direct investment models have set up satellite offices to attract talent and get broader exposure to deal flow. The Teachers' Retirement System of Ohio, which has had a direct investment program since the 1980s, has outposts in New York, San Francisco and Atlanta. The Teacher Retirement System of Texas, which has a newer direct investment program, opened a

London office in 2015 and has its eyes on a Singaporean location as well. While CalSTRS has no plans to branch out beyond Sacramento – where it is adding additional office space – Chan said the fund might consider adding secondary locations or opening the door to remote employees.

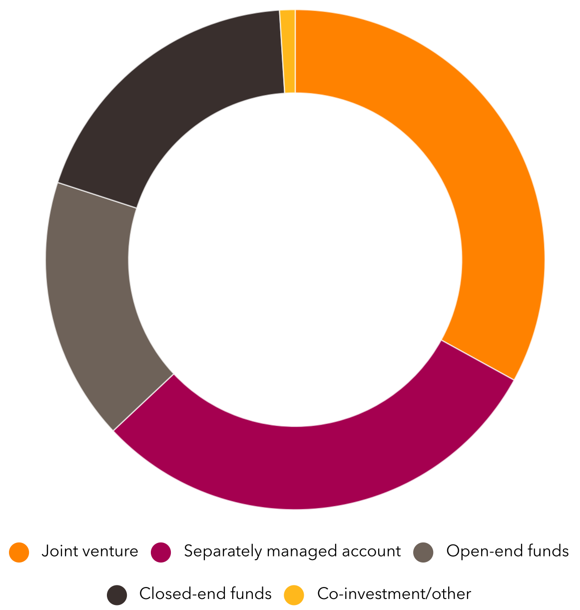
"We've tapped a lot of great talent in this location in Sacramento, but we've got to be realistic in thinking about how much talent also resides in San Francisco, LA and other areas," he says. "We've got to be creative in thinking about that, particularly if we think on the investment side that we'll eventually go from 180 to a little bit over 300."

A GROWING TREND

Like some other internationally investing institutions, the large US pensions have tilted their focus away from blind pool funds since the global financial crisis. Texas TRS, for instance, rolled out its principle investments program in 2014 and has already seen tangible results. When it implemented the strategy, just 24 percent of its real estate allocation went toward non-fund structures, compared to 60 percent last year. During that time period, its internal real estate holdings achieved a 14.4 percent IRR compared to 10.3 percent secured by its external managers.

CLOSER TO THE SOURCE

More direct vehicles accounted for nearly two-thirds of CalSTRS's real estate allocation in 2018



Source: *CalSTRS 2018 Semi-Annual Report, RCLCO Fund Advisors*

Other private asset classes have performed even better under the principle investment model. Texas TRS's direct investments in energy, natural resources and infrastructure produced a five-year IRR of 14.3 percent compared to 3.6 percent for the equivalent fund portfolio. During a public meeting in July, CIO Jerry Albright attributed the success to a single acquisition – which he did not identify because of the organization's privacy non-disclosure rules – that would not have been available through a commingled fund.

Albright said during the meeting: "A lot of that return came off of one transaction…and we made some fantastic money that we wouldn't have made had we just accepted what the partner brought to us."

CalSTRS' cousin, the California Public Employees' Retirement System, is also targeting a more advanced approach to direct investment. It aims to launch a pair of investment companies that would operate independently of the pension. This tack has become known as the 'Canadian model,' which refers to retirement systems in that country that have launched standalone investment arms: Cadillac Fairview by Ontario Teachers' Pension Plan, Oxford Properties Group by the Ontario Municipal Employees Retirement System, and Ivanhoé Cambridge by Caisse de dépôt et placement du Québec.

Of the decision to go direct, Eric Plesman, Oxford's executive vice president of North America, says a lot of factors come into play, including an institution's size and resources. But he tells PERE: "it ultimately comes down to the mandate, the level of control you want to have in your investment strategy and how much capital you need to deploy. It depends, but for us, it's been essential to the returns we've realized to date."

Ben Maslan, managing director of RCLCO, a real estate consultant hired by CalSTRS last year, said more US investors are looking to emulate the Canadian model by better aligning their interests with those of their managers. However, there is a significant amount of daylight between the two approaches, particularly when it comes to launching standalone entities. "The Canadian model is either an operating company itself investing directly in real estate, or it will partner with an operator to invest directly in real estate," Maslan says. "That latter part is where we see the American model moving, partnering with operators."

One such partnership is CalSTRS' majority ownership in Fairfield Residential, a multifamily real estate operating company based in San Diego, California. Earlier this year, CalSTRS bought a 65 percent stake in the firm from Brookfield Asset Management – the two entities recapitalized Fairfield in 2010 and brought it out of bankruptcy.

With roughly 1,200 employees and assets in 36 markets across the US, DiRé said the Fairfield investment is a prime example of how the collaborative model can expand CalSTRS' reach without overloading its internal capabilities. "If we can structure relationships that work for both parties, we don't' need to hire those people, we have those people through the relationships and it's much more efficient for us," he says. "We're not going to grow to that size of a staff, it just wouldn't make sense to run it, especially out of Sacramento."

Another pre-existing structure that fits the collaborative model is an infrastructure club deal between CalSTRS and Dutch pension manager APG, which is managed by Argo Infrastructure Partners, a New York-based manager. The two investors chipped in $250 million to the initial venture in 2015, which acquired Cross-Sound Cable, a high voltage direct current transmission system between Connecticut and New York. Last year, both committed an additional $300 million.

"This more direct style of investing not just saves fees, but puts us in a position to be more nimble in the marketplace," DiRé says. "In the case of real estate, having a direct relationship with developers or even asset allocators, that we can move faster to take advantage of opportunities just gets us better deal flow, size and structures of our relationships where we feel we have alignment of interests. That gets us fee savings, and the combination of those two things means we should yield higher returns."

MANAGING THE MANAGERS

As more large investors opt for direct approaches, managers are faced with a decision: accept reduced fee revenue or look for capital elsewhere. While some firms are unwilling to adapt to these more collaborative approaches, many have been happy to accommodate.

"It's a little bit bifurcated for managers," Walter Stackler, managing partner of Shelter Rock Capital Advisors, says. "Some fully discretionary fund managers are happy with what they have and don't want to change to a so-called collaborative, non-discretionary model. But it works well for the smaller managers as well as larger managers looking to expand their business into new product lines."

Several top managers, including those that have executed non-fund investments with CalSTRS either declined to comment, or were not available.

A managing director of another capital advisory firm who declined to be named says he has seen an influx of work in non-fund structures. Along with the desire to cut fees, many investors, including CalSTRS, want to hold onto stable, income-producing assets longer than most closed-end fund structures allow.

Others want the ability to say yes or no to certain acquisitions. Some of these arrangements can even be favorable to managers, he says: "The manager may prefer a smaller team at the limited partner level because they

don't have to deal with a larger team of people micromanaging them and poking holes in their assumptions as much."

Chan says established managers have been more accommodating of the collaborative model than their smaller contemporaries. Upstart managers hoping to take on discretionary capital, meanwhile, would do well to prove their worth with more collaborative approaches DiRé says: "It's still managing money. It's still managing strategies." ■

IDR raises $1.5bn for first-ever ODCE index fund – Exclusive

Texas TRS seeded the fund with $990m and other investors followed suit, looking for liquidity and a passive approach to core real estate investment.

By Kyle Campbell

Investors Diversified Realty, an Ohio-based manager, has raised $1.5 billion of capital for its open-end vehicle that mirrors the NCREIF Fund Index – Open-end Diversified Core Equity, PERE has learned.

The Teachers' Retirement System of Texas seeded IDR's Core Property Index Fund with a $990 million commitment, helping the vehicle achieve a first close on more than $1 billion in January 2019, a source familiar with the fund said.

Since then, the Los Angeles County Employees' Retirement Association has committed $250 million to the fund, and the Michigan Department of Treasury, the investment fiduciary for the State of Michigan Retirement System, added $25 million. Core Property Index Fund has 12 investors to date, including pension funds, endowments, foundations and family offices, all within the US, the source told PERE. IDR will open the platform to non-US investors next year.

Texas TRS backed the index fund because it provides access to core real estate at scale at a low-cost basis, according to a a newsletter distributed to investment partners in July. IDR charges a management fee between 20 and 40 basis points, PERE understands. Jared Morris, the investment manager who led the transaction for the pension, said the structure allows investors access to greater liquidity. He added that the fund offers the ability to invest passively in core real estate so investors can "focus resources on other areas of the portfolio to generate outsized returns." Investors also have the option of increasing exposure to specific vehicles within the fund index.

The product is the first index fund designed to provide exposure across the NFI-ODCE, which consists of 24 funds that manage $260 billion of gross real estate assets. The fund is aiming to replicate the returns of the index and is invested in 21 of the ODCE funds on a value-weighted basis. The largest allocation is to the largest fund, JPMorgan Asset Management's Strategic Property Fund, and there is proportionately smaller exposure to the other vehicles. The three smallest ODCE funds – EverWest Real Estate Investors' GWL US Property Fund, Goldman Sachs Asset Management's US Real Property Income Fund and New York Life's Madison Core Property Fund are not included.

Texas TRS analysis showed that IDR modeled a tracking error of 12 basis points or fewer compared with the ODCE index, a low variation that Morris attributes to the stability of the underlying assets in each fund.

After performing well since the global financial crisis, the funds in the ODCE index have seen a drop-off in performance over the past two years. As of the third quarter, the NFI-ODCE saw a total return of 1.31 percent gross of fees – an uptick from the 1 percent return the previous quarter but significantly lower than the 2.09 percent achieved in Q3 2018. One-year gross returns registered 5.59 percent as of the third quarter, down from 8.68 percent during the previous four quarters. Falling asset appreciation growth since early 2018 has been a drag on the performance of these funds.

Despite the lackluster performance of the ODCE index in recent years, institutional capital continues to flock to its underlying funds. Although some that are overexposed to retail, such as UBS Trumbull Property Fund, have not joined in this success, the products that lean more heavily on logistics and multifamily have investors queuing up for entry. IDR's Core Property Fund appears to be the latest alternative offering in the evolving core real estate market. ■

US debt funds fight for territory

Private real estate debt funds need to prove their value to investors in a more crowded and competitive market.

By Michelle Phillips

The real estate debt landscape in the United States has changed dramatically since the 2008 financial crisis. Whereas banks and government enterprises were the unquestioned dominant players in property lending before the Lehman Brothers' implosion, 10 years later private equity funds have emerged as a significant source of capital. The $18.9 billion raised for US private debt strategies during that time is impressive, especially considering the state of the market before the collapse.

"Real estate debt as an asset class for investors really didn't exist until after 2008," says William Lindsay, co-founding partner at real estate debt firm PCCP. The firm is one of the few that can claim to have invested in real estate debt even before the crisis hit, albeit using methods other than private funds at that time. Lindsay explains the market was largely overshadowed by the over-leveraged financial institutions, meaning his team had to find creative ways to partner with them. It was only after the crisis that a space formed for private real estate debt funds.

Since 2010, the asset class has grown in both capitalization and acceptance among the investor community. There are an increasing number of successful funds in the US market, and even more if multiregional funds run by the likes of Blackstone are included. Indeed, JLL's head of funds advisory for the Americas, Jerry Cain, says he has been surprised by the volume of capital flows into US property debt in the past 36 months.

"Post-crisis and a few years after, debt was a bad word; but as it is still widely accepted that the banks are under restrictions and cannot do some of the traditional lending, there is more of a need for the private debt space," he says.

"From an [investor] perspective, debt is now a more widely accepted asset class in a fund structure, complementing their equity strategy."

> ***"Post-crisis and a few years after, debt was a bad word..."***
>
> Jerry Cain
> **JLL**

Although global real estate debt fundraising saw a precipitous 48 percent drop worldwide in 2018 – the lowest fundraising for real estate debt globally since 2011 – the US saw only a 29.6 percent drop year-on-year, even when the large multiregional funds were excluded, such as Goldman Sachs' record-breaking $4.2 billion Broad Street Real Estate Credit Partners III. In fact, given that 2017 was the most successful fundraising year on record, with almost $9.9 billion raised, the 2018 downturn is moderate compared to the 46.5 percent drop in 2014, according to PERE data.

Whatever the numbers may say about the past decade, the future of this young market is hardly set in stone. Investors and managers alike must consider whether private equity real estate debt fundraising is just a temporary opportunity to sustain the market while bank lending gets back on its feet, or whether the industry will evolve to remain relevant.

CROWDING IN

Increasing acceptance of a shiny new asset class has led to the US real estate debt space becoming crowded – not just in deals, but also in fundraising. Cain knows of other equity sponsors, such as hedge funds, trying to take on some debt origination strategies in real estate, and more managers add it to their traditional equity strategies.

"The senior loans market has really exploded," Lindsay says. "[PCCP] used to be one of just a handful of real estate debt funds out there, and today we have about 20 to 30 competitors."

What used to not even be considered its own asset class is now recognized as a strategy between fixed income and real estate, he explains. Real estate

debt has become popular on every level – from mezzanine to REITs to private structured deals – and everyone seems to want a slice of the pie.

One factor contributing to this crowding tendency is returns compression in more traditional real estate investments. Most opportunistic funds in the US are now offering approximately 15 percent returns, while real estate debt is not far behind with 10-11 percent on average, with some funds offering as high as 13 percent. With debt funds offering much better downside protection, it seems a logical choice.

"Many equity funds have seen a lot of pressure on returns, so on a relative value basis [real estate debt] is attractive," says Peter Weidman, global head of real estate credit at the Goldman Sachs Merchant Banking Division. "We've seen in past cycles, and we're definitely seeing it now, the compression on spreads, pressure on yields, pressure to deploy capital." He adds that this pressure is not unique to private funds.

Cain also says opportunistic deals in the US are harder to come by at this point in the cycle. In order to chase higher returns, some US investors are becoming more open to non-gateway but institutionalized markets they would not have considered 10 years ago. Third- and fourth-tier cities like Birmingham, Alabama and San Antonio, Texas are getting investor attention. However, when investors take that kind of risk, protecting their investment becomes a high priority.

"Compared to other available real estate investments, there are a lot of defensive characteristics to our kind of investing, especially later in the investment cycle," Weidman says. "You can have a deterioration in [property] value, and still recover the full amount of your principle." In fact, some investors are so keen on this kind of real estate investment that they are beginning to make direct investments, he adds, becoming competitors to the debt funds themselves.

International investors have also made a big splash in the market, Cain says. The tens of billions of potential investor dollars pouring into the US market would be enough to make many fund managers salivate and they have not neglected to take advantage of the opportunity. PCCP had no foreign capital in its 2012 vintage fund, PCCP Credit V, but in its most recent PCCP Credit IX, it accounted for 30 percent of the fund's $1.25 billion total capital.

There is another reason international investors in the US gravitate toward debt – tax structure. According to Lindsay, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) requires a 30 percent withholding on equity investment returns. But for debt investments, that is reduced to as low as 10 percent of the total returns, which makes returns for equity and debt investments almost neck-and-neck – maybe 10.5 percent versus 9 percent. The consequent interest of international investors combined with that of US investors has led to a market "flush with capital," Lindsay says, which might be worrying to those who remember the pre-crisis real estate market.

DEFENSIVE POSTURE

Generally, however, investors are not overly worried about another big crisis in real estate debt, even if they know that price corrections are on the horizon. In fact, planning for corrections in the market is what will prevent another real estate crisis in the country, some argue. Cain points out that investors in real estate debt have become savvy and are keeping an eye on policies or major trends that warrant caution. Overall, he has been impressed by their caution and rigor as they foray into this new asset class, with multilayered due diligence taking as long as six months in some cases.

"Even since we raised our first fund [in 2009], the investor base has become more educated on the strategies within debt," Weidman says. Over time, investors had to become more sophisticated on equity investments, understanding the many different strategies and risk-return profiles in the various asset classes. "And now, I think we're starting to see more of that kind of differentiation and understanding in the investor base on the debt side," he explains.

It is beyond cliché to talk about the importance of track record for fund managers, but in US real estate debt, it takes on a whole new meaning: with the disaster of 2008 fresh in most investors' memories, there is a lot to be lost. Even with the new entrants to the market, the fund sponsors need to have proved their strategies through downturns, JLL's Cain says, which means only the high-quality sponsors are being capitalized at this point in the cycle.

"There is always concern about risks, and that's why [investors] are so meticulous in their underwriting," Cain says. Cain finds that investors are looking for flexibility, quality and "one-stop shopping": a new pattern where investors want a fund manager they trust which can "take all their capital stack in one go, providing the senior and the mezzanine for real estate debt." But every investor's idea of risk is different, and they check new investments at the portfolio and fund level before committing.

"In real estate, everyone touched the stove and got burned in 2007-08," Lindsay says. "They survived, but they still remember it." He recalls investors asking detailed questions about what PCCP learned from the GFC, about their credit process, and whether the firm has "thought through everything that could possibly go wrong."

"Investors really appreciate that we find something that works and stick to it," Weidman says. He hears concerns from investors about funds taking more risk and trying different strategies to get the same or higher returns, but that is not what these investors want from their real estate debt investments – they want a consistent strategy that they can rely on for steady returns, especially because in debt investments there is no upside.

"[Investors] want to understand that there is limited downside – they already understand the limited upside," Lindsay concurs.

LOOKING AHEAD

Even if the number of managers levels out over time, fund managers and analysts alike believe real estate debt funds are here to stay. Cain sees the past two years as the second wave of real estate debt fundraising and believes 2019 will be a crucial year for determining how the US market will shape up. JLL's placement agent business is itself banking on the continued success of this market by looking for a real estate debt fund manager to partner with.

"I think we're far enough into the cycle, there are enough structural changes in the banking system, and enough investor demand for this to be a permanent shift in the landscape," Goldman Sachs' Weidman adds. The fact that funds can react to investment opportunities quickly and structure their loans creatively – in ways banks simply are not doing anymore – is a significant draw for investors, he explains. "If we were going to see that change back to the banks dominating this space, we probably would have already seen it happen."

Lindsay adds that some tactically minded investors are just in real estate debt to replace core investments temporarily as prices go up. "But my experience is once we show them what we can do in real estate debt, investors like it – and I don't think we're going to lose those investors." ■

Why some investors are passing on funds and cross-border deals

For the first time ever, interest in closed-ended commingled funds has dropped, a study published by Hodes Weill and Cornell University's Baker Program in Real Estate has found.

By Lisa Fu

Investor interest in traditional closed-ended fund structures and cross-border investments is waning somewhat.

For the first time, investor interest in the traditional private equity closed-ended fund structure has decreased, according to the 2019 Investor Allocations Monitor study by boutique advisory firm Hodes Weill and Cornell University's Baker Program in Real Estate. Around 80 percent of the 212 global institutional investors surveyed showed an interest in fund investments, down from 93 percent in 2018.

The dip in interest can be attributed to the larger investors looking to drive down the cost of fees, and more importantly, maintain control over key investment decisions, according to Hodes Weill co-founder and co-managing partner Douglas Weill. Smaller investors that do not have the scale to pursue joint ventures and separately managed accounts have continued to commit to funds but are consolidating manager relationships – now the top-10 managers are raising half the capital in the market, he added.

Inbound capital flows into US real estate have also taken a hit, largely due to currency volatility.

"Investing in US dollar-based strategies, if they [non-US investors] require hedging back to their local currency, has been very expensive," Weill said. "So you've seen a slowdown in offshore capital coming to the US."

For Chinese institutions, once the most acquisitive US real estate investors, the reasons are twofold: the Chinese yuan has depreciated against the US dollar and its own government has placed strict capital controls to discourage international investment.

Meanwhile, investors from other Asian countries like Japan and Singapore have turned their focus to investing in Europe, given favorable hedging costs. Asian investors are also investing more inter-regionally than they have in the past.

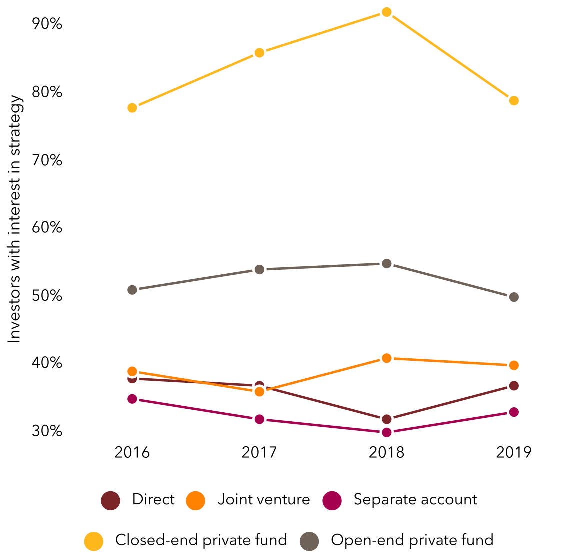
Weill also pointed out that US investors are increasingly preferring to invest domestically as economic growth continues to be stronger at home.

While investor preferences for investment structure and geography are changing, their interest in real estate as an asset class remains robust. Despite trade war concerns, cycle risk and other geopolitical issues, 96 percent of investors indicated that they would like to be active in real estate. This marks a seven-year high for how active investors say they would like to be in deploying capital.

Sustained interest in the asset class is being driven by real estate's continued strong performance, an uptick in investment realizations and the reverse denominator effect, according to Weill. In 2018, real estate portfolios returned 8.8 percent net of all fees, around 50 basis points higher than the average target return of 8.3 percent, according to the report. ■

CLOSED-ENDED FUNDS FALLING OUT OF STYLE

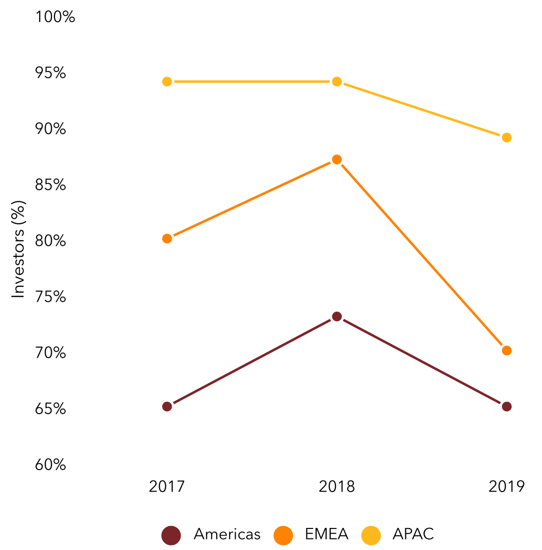
They are still the most popular but 2019 marks the first year where allocation to the product decreased



Source: Hodes Weill and Cornell University

INVESTORS MAKING CROSS-BORDER INVESTMENTS BY LOCATION OF INSTITUTION

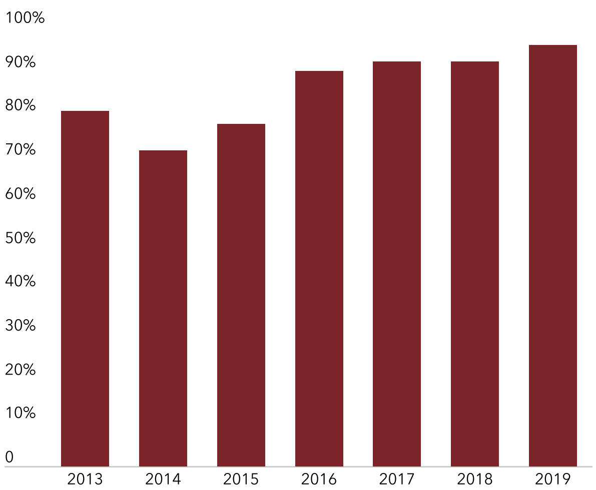
Outbound capital is coming back home across all three regions



Source: Hodes Weill and Cornell University

ACTIVITY AT A 7-YEAR HIGH

96% of institutions said they are actively investing in real estate



Source: Hodes Weill and Cornell University