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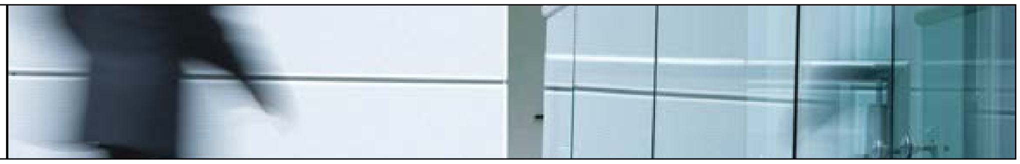

Who Moved My Capital Source?
Adapting to Change in Real Estate Investment Advisory

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Real estate investment advisors are skilled at foreseeing and adapting to changing conditions in markets that can affect property yields. It remains to be seen how well firms will adapt to evolutionary change of another sort: Traditional capital sources are facing long-term decline, and the investor types picking up the slack have different ways of approaching the market. To thrive over the long term, investment managers must develop systems for serving new client types, without abandoning their still-active client base in the process.

Demand for investment-grade commercial property is strong and getting stronger. Institutional capital allocations to U.S. real estate investment are increasing at a rapid pace, as pension funds seek core and opportunistic investments across an expanding range of property types and cities.

Despite the flood of cash, many investment advisors are finding it more difficult than ever to raise capital and execute solid deals. Investment managers often say it takes twice as long to get half as much done as it did a decade ago. While there are many factors that contribute to the challenging environment, arguably one of the most significant trends affecting the business involves the shifting landscape of capital sources.

The real estate investment advisory business was created to serve private and public defined benefit (DB) pension plans, but these plans are in decline. Pension Fund Guaranty Corp., the government agency that insures self-funded corporate plans, has seen corporate plans fall from 112,000 in 1985 to just 22,000 in 2013. The percentage of households covered by DB plans today is 31 percent for all workers, and just 18 percent for private sector workers, according to government statistics. Most employers today offer defined contribution (DC) options such as 401k plans instead of DB plans.

This shift in corporate retirement benefits has major implications to real estate investment. Large DB plans tend to allocate a percentage of funds to direct investment in commercial real estate, as a way to match long-term liability with long-term investments. With DC plans, each individual can increase or decrease exposure to a particular investment

Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

class or sector at a moment's notice. That flexibility is served by liquid investments such as REITs but is not very conducive to direct investment strategies.

That doesn't mean pension fund investment is dead. In fact, total DB fund assets have more than doubled over the past two decades, from about $1.5 trillion in 1991 to $3.5 trillion in recent years. Ominously, however, total assets have remained steady in the past several years despite the rise in the stock market. The reason assets are not declining along with the number of DB plans is that these plans take several decades to wind down as covered employees eventually retire and collect benefits through the end of their lives.

So private DB plans are not dying a quick death, but they are becoming less of a force in real estate investment than they used to be. DB plans continue to be the norm in the public sector, but some are concerned that this may change over time. Pension obligations are said to contribute to events such as Detroit's bankruptcy and Illinois' massive debt load, as governments have the same difficulty as corporation with funding the long-term pension liabilities.

The upshot is that, while no one sees a steep decline in DB real estate, investment managers are aware that to grow assets under management and expand their client base, they will have to look elsewhere. Some of the biggest sources of competition for deals, such as REITs and hedge funds, possess the internal acquisition and asset management expertise and don't need third-party advisors or managers.

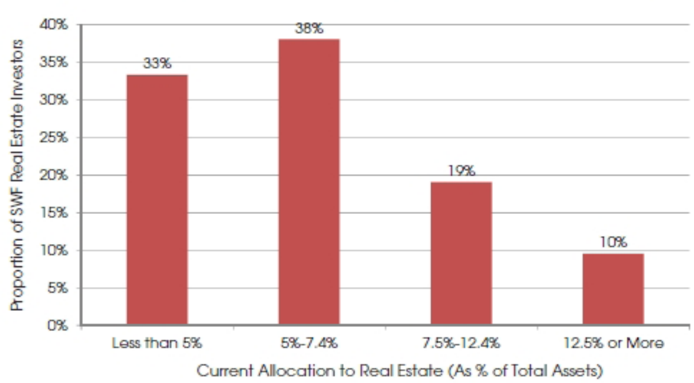
To replace capital from DB plans over time, investment managers are looking at several segments of the investment market that happen to be increasing their interest in the U.S. market. The most talked-about capital sources currently include a new wave of foreign institutions, sovereign wealth funds and family offices. Each of these groups has its own set of strengths, challenges, requirements and risk tolerances, and there can be wide variation of these factors within each category.

Foreign investors - There's actually nothing new about overseas institutions looking to invest in U.S. real estate markets. Investors from the UK, Western Europe, Japan, Canada and Australia have been active in U.S. real estate investment for decades, and anywhere there has been strong wealth creation within a country, U.S. real estate investment has usually not been far behind. Real property is viewed as a solid long-term investment, and the U.S. tends to offer better cap rates and greater economic and political stability than most countries.

But while the concept of foreign investment is not new, there is a rising influx of capital from countries like China, South Korea and the United Emirate Republic. These new capital sources can be difficult for U.S. based investment advisors to tap into without a market presence in the country of origin. In addition, new investors unfamiliar with U.S. regulatory and market environments are likely to take more time and ask more questions than more experienced players. For investment advisors accustomed to the sophistication of established institutional investors, the extra time and energy needed to serve new players—exacerbated by language and time zone barriers—may not seem like the best growth strategy.

Sovereign wealth funds – Another form of foreign investment, sovereign wealth funds (SWFs) are state-run investment vehicles to diversify risk. Globally, SWFs have surpassed $5 trillion in assets and have invested nearly $200 billion in real estate, with 72% preferring North American investment over other regions.

Breakdown of Sovereign Wealth Funds' Current Allocation to Real Estate



Source: 2014 Preqin Sovereign Wealth Fund Review

SWFs have significantly increased their presence in U.S. real estate markets in recent years, but their overall allocation to real estate is still only about 8 percent. Real property is a good fit for these long-term-hold investors, so U.S. investment levels will probably continue to rise. Like other foreign investor types, however, SWFs may prefer advisors to have a presence in their own country as well as strong U.S. coverage. For most U.S. based investment management firms, capturing a share of SWF capital may require a lot of time and money to cultivate relationships.

Family offices - The number of U.S. households with more than $25 million in wealth reached a new high of 132,000 recently, according to a report from Spectrem Group. So it's no wonder that we're also seeing a rise in family offices, private companies that manage investments for one family with wealth typically exceeding $30 million. Real estate investment is common for family offices, particularly larger ones that can accommodate large, long-term investments.

As an advanced form of personal wealth management, family offices tend to take investments more personally—for example, family members often want to buy properties they can drive past to check up on their investments. Family offices are also more unforgiving about downside risk than institutional players. As a result, these capital sources need a lot of hand-holding and personal service, which can be a difficult adjustment for an investment manager accustomed to the sophistication and hard-nosed decision-making of DB plan managers.

In fact, new capital sources of all types tend to need more personal service, more information and more time to make decisions than established investors with set criteria. Many real estate investment managers are opting to continue their focus on pension funds, which are still major players for at least the next couple of decades, rather than investing the time and money in cultivating new client types.

That leaves the competitive field more open for advisors that can adapt their capabilities and culture to newly emergent investor types. Advisors' experience with core versus value-add investments, or with gateway versus secondary markets, should be a factor in determine what types of clients they will pursue going forward.

Investment Market Shifts

The dynamics of capital sources and their needs also affects the property sales market itself. Capital sources with less experience may require more information from sellers to become comfortable making bids. There's likely to be less discretionary capital for investment management firms to make decisions on behalf of clients, which in turn extends the length of time needed for due diligence and closing of deals. Investment managers and sellers alike will be asked questions they haven't encountered before, and deals will more often be affected by tax and regulatory considerations requiring a learning curve for investors and their representatives.

Commercial real estate has undergone an evolution over many years to the point that it is now regarded as an investment asset class on par with stocks and bonds. The process has been difficult at times, but it has opened up a wider world of opportunity for players in the investment management business. Now we're seeing a new branch in the evolution that creates additional challenges and opportunities for firms with the resources and the will to expand their client base and, if all goes well, increase market share.

Summer Street Advisors, LLC (SSA) is a commercial real estate and financial services advisory firm. SSA offers a rigorous, data driven approach in providing commercial real estate and loan investment valuation and analysis, transaction due diligence, bank and REIT advisory, asset/portfolio management and loan underwriting.

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