



MEMORANDUM

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To: PCA Clients

From: Paul Mouchakkaa, Pension Consulting Alliance, Inc. (PCA)

RE: History Lessons


The famed Irish playwright George Bernard Shaw wrote *"We learn from history that we learn nothing from history."* Although images of black swans may come to mind when pondering the depth of this quotation, but consider another interpretation - simply the mistakes of the past tend to be repeated in the future. This is apparent when dissecting the current downturn in the commercial real estate market. In the early 1990s, the correction was driven primarily by oversupply of space; the current real estate market correction has also been driven primarily by oversupply. Only this time it was oversupply of cheap and complex debt.

The recovery in commercial real estate will likely be quite different from that of the 1990s. First, in the 1990s there was little capital available to invest and help stabilize the real estate market. Also, banks did not have the ability to extend maturities so easily which led to more distressed buying opportunities in the 1990s. According to Institutional Real Estate Incorporated, it is estimated that there will be \$34 billion in new commitments to real estate in 2010. This is in addition to an estimated \$135 billion of uncalled capital already committed to existing real estate investment vehicles. These two elements have led to few transactions in today's marketplace and much more obscurity regarding when the clouds may lift. But how did we get into this situation to begin with?

Many investors, investment managers and consultants persuaded themselves into thinking that real estate was moving into a "new world order," and the fundamental laws of supply and demand were no longer applicable. Unfortunately, some have had to (re)learn this lesson harshly and at a steep price. It is clear that the investment community is on high alert and terms like "investment discipline," "risk mitigation," "deleveraging" and "alignment" are now flying around with increasing frequency. But, none of these concepts are new or groundbreaking in the real estate investment industry. These concepts were simply ignored or not adhered to when the market was hot. So what can we learn from the 2000s that we could not learn from the 1990s?

Clearly, a substantial portion of the correction is simply doing what markets always do, but another considerable dose of the losses endured thus far in commercial real estate were also exacerbated by "nonmarket" forces. It is with these nonmarket forces that an investor can exercise control and reduce the impact of the next market correction, and on which this paper will focus. These key areas include:

- portfolio monitoring and construction;
- investment pacing;

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- due diligence; and
 - risk and return expectation setting.

This paper will not provide an instruction manual for the future, but will simply point out some lessons learned from this last market cycle in commercial real estate and how an investor can be better prepared for the future.

Know Your Portfolio

Pie charts are not necessarily the best way to actively manage a real estate portfolio. All investors must be aware of what they own in their portfolio. Because the investment manager community has overlapping strategies or mandates, investors can end up competing against themselves. To avoid overconcentration, an investor must actively and consistently monitor the holdings in their real estate portfolio.

The key areas to focus on are: property type, geography, vintage year, and life cycle. These exposures should be monitored on both a gross (i.e., inclusive of both debt and equity dollars) and net basis. Limits are found in most institutional investors' policy guidelines. However, almost all of them describe exposures on an equity-only basis which does not necessarily reflect the true exposure to the various segments, especially when the investments may have been structured utilizing recourse debt.


In addition, the amount and type of debt (e.g., recourse, cross-collateralized, fund level, property level) should be monitored, as should debt maturities. Grasping the structure and duration of debt within the real estate holdings is a powerful tool for navigating through a difficult economic climate, and it also provides insight into the risk within a given investment partnership.

Finally, better systems and monitoring of both investment and leverage exposures can be tools for guiding future investment decisions, ensuring that investors are not moving up the risk curve at too fervent a pace and not doubling-down in a certain sector or strategy. Improved monitoring will lead to more portfolio-level optimization and less deal-level optimization, which over the long-term is more likely to support investment objectives.

Pace Yourself

Nobody can consistently know the top or bottom of a market cycle. Therefore, investors should never “slam the brakes” nor “floor it” when it comes to investment pacing. Every investor is vigilantly watchful of their allocation as they should be, but making large allocations at certain points in time to hit targets or not making any investment at certain points for a prolonged period, are both tantamount to making a market bet.

Fixed-target allocations cause numerator and denominator issues, and investors must be wary not to overreact to changes in their allocation too hastily. There must be continued focus on fundamentals throughout the market cycle and its effect on allocation issues. During the recent run-up, several investors lost sight of cap rates, loan-to-value ratios and income growth, and they chased return. Further contributing to this trend were managers motivated to maintain or even increase investment in order to earn fees. History has clearly shown us that the private commercial real estate market is highly cyclical and the upside and downside cycles generally have long tails.



With hindsight, it is clear that many transactions made early on in the 2000s have generated strong returns, whereas those consummated from 2005 to 2007 are generally experiencing significant stress. Consistent hold-sell analysis is one key discipline that should be respected. Every day that an investor does not sell an asset, that investor is buying the asset. Having a hold-sell analysis and scrubbing the underlying assumptions therein is critical to assessing whether an investment is worth holding onto for future benefit or worth liquidating to reap presently available profits.

The point here is that, investment vintage really matters. It is imperative that investors not try to time the market by selling off significant amounts during the perceived top, or cease investment completely at the perceived bottom. Furthermore, the vintage-year of investments should be carefully monitored, much as property-type and geographic exposures are monitored.


Financial Structure Matters

One of the common themes throughout the current real estate market correction is that leverage is bad. However, that is not necessarily a completely accurate statement. Through one lens, leverage, when applied judiciously, can actually be a downside protector. Although seemingly counterintuitive to the fact that leverage can materially amplify returns on the upside and downside, the protective potential of leverage bears out in the following example.

Let's test the above notion regarding leverage by taking it to an extreme. A strong argument could be made that if during 2005 to 2007, an investor had leveraged their investment at or close to 100%, and structured the debt so that the investor maintained the option to relinquish the property to the lender in the event of greater than anticipated distress at the property level, the investor would have experienced a significantly smaller loss of equity capital. This argument does not necessarily advocate this method as a future strategy, but is merely an extreme example to make a point. The key premise is that the leverage employed would have to be property-level, long-term, fixed-rate and nonrecourse debt. In theory, when a remargining event occurs, an investor could simply "walk" from the assets they believe will not have long-term value. The use of leverage in this manner would ostensibly give the investor a call option. Therefore, one can see how leverage is not necessarily completely evil. It really boils down to the poor structure of the leverage.

Furthermore, during the recent run-up, subscription debt was employed by many investment vehicles at the urging of investors and consultants. However, the risks of these revolving credit facilities were not completely understood and/or were not carefully underwritten. The use of fund-level debt led to suboptimal investment decisions whereby a pool of assets had to be rescued when perhaps only a subset of the assets were actually worth saving. Additionally, the use of the subscription debt severely impaired alignment. By staving off the capital call an investment manager can accumulate enough fees to meet its co-investment obligation, thereby rendering the co-investment essentially a "flyer" to the manager, causing severe misalignment. The delay in the draw of capital can also dramatically inflate the return and, commensurately, the incentive fee due to a manager, when for all intents and purposes the return on investor capital was not truly as high as portrayed.

Going forward, investors need not eschew leveraged real estate investments entirely. However, investors do need to fully understand the type of leverage employed. A general rule of thumb is



that if it sounds very complicated, it usually is very complicated. If an investor cannot completely understand the structure employed, it should be avoided until it is fully understood.

Compare Apples to Apples

Many investors moved higher up the risk curve during this past run-up and it was primarily driven by the premise that returns for noncore investments would meet the return parameters many investors were seeking at the time.

However, the ability of investment managers to actually achieve those returns should have been more carefully scrutinized. First and foremost, unleveraged returns were disregarded. The notion of unleveraged returns gets to the very heart of comparing apples to apples. If a core fund meets with a prospective investor and pitches a proposal targeting a 9% leveraged return using 30% leverage and a value-added fund manager comes in and pitches a fund targeting a 12% leveraged return using 65% leverage, which proposal is truly better on a risk-adjusted basis?

Contrasting the two proposals over a comparable hold period on an unleveraged basis is a key discipline investors should implement for the future. In the example above, the unleveraged return would show a small difference between the core proposal and value-added proposal. Therefore, on a risk-adjusted basis, the core proposal might be a better alternative.


Stripping out the leverage allows the investor to see more clearly if they are being paid for the additional risk they are taking. Furthermore, it clearly delineates real estate risk (i.e., core stabilized assets versus development) from risks inherent to utilizing leverage. These two risks are of critical importance in underwriting and analyzing any proposal, but they are independent of one another and should be assessed in that fashion.

Finally, underwriting assumptions are at the very foundation of what drives a targeted return of a given deal or investment partnership. If those assumptions are premised on overly aggressive market assumptions or take into account large amounts of leverage, they can seriously impair an investor's ability to judge the merits and, more important, the risks associated with that proposal. Investors should ask about estimates in rental and income growth, the initial and exit cap rates, how timing impacts projected returns. These and other key metrics should be compared to those prevailing in the current macro- and submarket environments as well as those that have prevailed historically. Additionally, by performing sound sensitivity analysis an investor can better understand the risks inherent in a potential investment, as well as the impact of potential setbacks or adversity to the proposal at hand.

Trust but Verify

Every investor has investment managers that have performed well on their behalf. However, no investment manager should receive blind faith. Although a given manager may have done well in the past, there is no guarantee this will continue in the future. Many organizations change and grow over time and require monitoring. Any new fund offering should receive the same amount of careful and diligent underwriting the third time as it received the first time.

As the flood of capital kept pouring into the commercial real estate market in the most recent run-up, many managers were taking on new risks either through financial structuring/engineering or by entering new sectors or markets. The fact that these managers



had an established relationship and/or track record in a given niche gave investors more comfort in permitting these new strategies. But, management firms change all the time. Employees change, firms are acquired or go public, or companies change direction or focus.

Unfortunately, comfort can breed complacency, both for the manager and for the capital source. And new risk combined with natural change within a company is not an appropriate environment for complacency.

An investment manager deserves trust and discretion within their mandate, but monitoring and verification are part of the investor's responsibility. A new manager proposal should still go through a full-blown due diligence process to discover if the requisite skills are in place to execute or to ensure that nothing has materially changed in the organization that could cause alignment issues or conflicts. As we all know, the world keeps on turning and rarely does anything stay the same.

Conclusion

The points above are not meant to be collectively exhaustive, but suggest the old adage about "an ounce of prevention." We can collectively make better decisions going forward by ensuring that we:

- consistently monitor exposures and leverage positions/structures;
- do not get tied up in trying to time the market;
- understand the risks being taken before actually taking them; and
- apply consistent and careful diligence in underwriting various proposals from all investment managers at all times.

This is not a panacea and will not totally prevent investors from future losses, but it can better position that investor to weather the next storm.

As we have seen, no market correction is exactly alike, but the fundamental theoretical economic underpinnings do have similarities. Investors can only focus on the areas over which they can exercise control. As the real estate investment industry evolves and (hopefully) cultivates greater transparency, there will be new opportunities and structures availing themselves to investors and, therefore, new risks. Keeping in mind the concepts outlined here during all points in a cycle should serve investors well and reduce the impact that nonmarket forces can have on deteriorating returns in the next market correction. As Winston Churchill said "*History will be kind to me, for I intend to write it.*"