Finance Column

Institutional Investors & CRE

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For as much as the great recession has created turmoil, it has also ushered in a unique opportunity to improve on tradition. In the realm of institutional investors, this opportunity comes in the reassessment of how they are investing their capital in commercial real estate.

In pre-recession years, most pension funds followed a traditional model, investing in co-mingled funds and relying on fund managers to place capital using a very broad investment strategy. On the upside, this allows investors to move large amounts of money in one brush stroke so that the investor can achieve a market-based return (Beta) for their allocation. On the downside, it limits the input of an investor to select specific investment strategies where returns can be enhanced through active management by an operating partner also selected by the institutional investor (Alpha). Additionally, investing in a co-mingled fund is often a lengthy process, requiring the fund to be substantially raised before a plan could be executed. Markets move very quickly and many times fund managers find themselves chasing return hurdles and strategies as markets strengthen.

While the co-mingled fund investment strategy is still the dominant model in the industry post-recession, some institutional investors have re-evaluated their traditional models and are allocating a portion of their capital directly to experienced national and regional operating groups. By working through these experienced operators, institutional investors have found an avenue to execute specific strategies faster and gain unprecedented access to the professionals who manage those resources at the grassroots level. As the familiarity of this strategy increases, so does the amount of institutional dollars being allocated to experienced operators with proven track records.

Compared to fund managers, who typically focus on “buying the market” and growing the revenue side of the equation to create value, experienced operators function as active, on-the-ground representatives whose results come from a hands-on approach to asset management, property management, leasing, construction and finance. They focus on maximizing value not only through increasing rental rates as markets recover but also by identifying opportunities to increase value by uncovering operational savings, decreasing expenses, and making capital improvements that will improve revenue or control expenses. This strategy continues to grow in popularity because it gives the institutional investor greater control over its investments and it often allows them to implement more nimble investment strategies.

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Part of this ability comes from a very different scale of investment. In the world of fund managers, transactions generally fall in two categories — above $75 million per building and below $75 million per building. Regional and local operators typically deal in assets below $75 million where there is less competition and more opportunity to add value.

Many fund managers eschew national and regional operators because they often are unable to meet the investment criteria set by fund managers and their consultants. While operators may know the ins and outs of commercial real estate, only the largest and most established shops have the investment track record, asset management and reporting capabilities, and back office support to meet the ever escalating demands of fund managers. Additionally, fund managers often lack the time and resources to source and fully vet individual operators.

Make no mistake, co-mingled funds are not going away. In addition to co-mingled funds, however, fund managers now have additional choices when making allocations. Look for allocations to operators to become more and more prevalent as the investment market continues to evolve.